

Basel's New Emphasis on Supervision and Implementation

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Good morning. It is a pleasure to be with you for the opening of the 2013 Risk & Regulation USA Conference here in New York. I want to begin by expressing my thanks to our organizers at CFPE for the chance to contribute to what looks like an important and timely program. As someone who arranged my share of conferences earlier in my career, I am impressed by the caliber of speakers you have assembled and I am confident it is going to be a useful occasion for all of your attendees.

I should probably explain that I am not a died-in-the-wool bank supervisor myself. Indeed, when I joined the OCC eighteen months ago, it was the first time in my life that I worked as a civil servant. My career up til then had been concerned with financial industry practice and public policy but largely as an outsider – as an economist and as a policy analyst working in think tanks and consultancies. Now I bring that experience to advising the Comptroller of the Currency on capital issues domestically, and representing him internationally at the Basel Committee, where I chair the SIG -- Supervision and Implementation Group. I find myself in the very middle of the policymaking process I have observed for the past twenty years and it is quite an education!

I would like to take the time I have been allotted today to talk about the two aspects of the current work of the Basel Committee that I help lead: the work on enhancing international practices of banking supervision and the progress that is being made to implement the Basel standards internationally.

I won't apologize for the fact that they are both by way of being background topics for your conference. For many of you, compliance risk is just one sort of risk you have to manage, and implementation progress around the world is not something you need to be concerned about day-to-day. Nevertheless, I believe they will provide some context for your discussions over the next two days because what we do in Basel today has a way of affecting what you do in New York tomorrow.

The Regulatory Program

As you know I am sure, regulatory agencies have two ways of exercising oversight over financial institutions – regulation, which is the business of making rules -- and supervision, which is the business of examining and supervising the activities of individual institutions.

In coordinating the international response to the 2008 crisis, the Financial Services Board and the standard setting bodies worked conscientiously to reform international financial regulation. As the standard setter for banking, the Basel Committee produced a set of revisions to international banking regulatory standards that was wide-ranging. Basel III, as it is known:

1. Raised minimum common equity capital standards from 2% to 7% of risk weighted assets;
2. Required banks to hold higher quality capital that would be truly loss absorbing;
3. Introduced the capital conservation buffer that internationalized the US prompt corrective action idea of automatic restrictions flowing from untoward declines in capital;
4. Added a macroprudential element to the regime in the form of a counter-cyclical capital buffer;
5. Introduced an international leverage ratio;
6. Imposed additional requirements on significantly important banks; and
7. Introduced the first international standards ever for liquidity and funding.

These seven areas were not all spelt out to the same degree. So the Committee has continued work over the past three years and reached agreement last year on several specific details of the framework:

- The Liquidity Coverage Ratio;
- A policy framework for dealing with domestic systemically important banks;
- Disclosure requirements for the new Basel III definition of capital; and
- Supervisory guidance for assessing the effectiveness of a banks internal audit function.

The goal immediately ahead for regulation is to complete by the end of 2014 all of the remaining work that came from the crisis. That involves an ambitious agenda:

- Completing work on the Liquidity Coverage Ratio;
- Reviewing the Net Stable Funding Ratio;
- Completing a review of the capital requirements associated with the trading book;
- Enhancing the treatment of securitizations to make the capital charge more robust and more risk sensitive;
- Strengthening capital requirements for OTC derivatives, margining and CCP exposures with a view to reducing the associated systemic risks; and
- Revising the large exposure framework.

In addition, the Committee is just launching two workstreams aimed at complementing these crisis-driven reforms:

- An examination of the need for a capital framework for interest rate risk in the banking book; and
- A review of the standardized approaches to capital adequacy for credit and operational risks.

These are both driven by the need to re-examine the capital standards in the interests of increasing their simplicity and comparability.

Supervision

Now, however, the time has come to shift the emphasis in international policy coordination back toward supervision. The Basel Committee made a start down that road in 2012, with the publication of the revised Basel Core Principles of Effective Supervision.

These principles were originally issued in 1997 and have been used by countries since then “as a benchmark for assessing the quality of their supervisory systems and identifying future work to achieve a baseline level of sound supervisory practices.” The IMF uses them too, as one of the standards they apply when they assess their member countries in their Financial Stability Assessment Programme. The principles cover:

- preconditions for effective banking supervision, such as sound and sustainable macro-economic policies and a clear framework for crisis management, recovery and resolution;
- supervisory powers, responsibilities and functions, such as independence and accountability of the supervisory authority itself; and
- prudential regulations and requirements. These cover the familiar areas of
 - corporate governance
 - risk management
 - capital adequacy
 - credit risk
 - problem assets, provisions and reserves
 - concentration risk
 - transactions with related parties
 - country, market, interest rate, liquidity and operational risks
 - internal control and audit
 - financial reporting and external audit
 - disclosure and transparency and
 - abuse of financial services.

Believe it or not, the Core Principles are a good read for anyone interested in supervision and it is written in a way that is just as applicable to the United States and the European Union as it is to the smallest and simplest of banking systems in the developing world.

The 2012 revisions reorganized the earlier draft and gave new emphasis to the corporate governance and risk management processes.

In parallel with this update – partly driving it as well as complementing it – has been the work of the FSB supervision group, the Supervision Intensity and Effectiveness Group. Their work has focused to on governance – both corporate and risk – and on culture – a perennial and difficult topic.

We in the Basel Committee are now identifying areas where we will concentrate our efforts to raise supervision standards, building upon the Basel Core Principles.

- First of all, we are going to review 2002 guidance on supervising weak banks. A lot of experience has been garnered about this topic during and after the crisis which should be taken into account.
- Secondly, we will review more recent corporate governance guidance that will take into account the recommendations of an SIE November 2012 report and the FSB SCSI thematic peer review on risk governance that was just published. Among other things, this corporate governance update will look at best practices and approaches for succession planning; performance expectations of key positions within banks; and the need for formalized processes to promote constructive interactions between the Board, senior management and regulatory officials.
- Thirdly, we are starting up a review of the workings of international supervisory colleges – with which we now have some experience for G-SIBs. What are the practices that work and what does not for sharing information and coordinating regulatory actions across national boundaries? This also promises to contribute to raising standards of effectiveness in supervision internationally.

Beyond these three new workstreams, we are looking at three or four other topic areas where we see potential to do useful work internationally.

- First of these is on business models. How useful is it for supervisory agencies to examine the business models of the banks as a way of identifying emerging risks, and, somewhat separately, how much impact is regulatory reform having on bank business models and with what consequences. We are actively discussing ways to deepen our understanding of both topics.
- The second of these is the prudential treatment of assets. One of the many findings of the financial crisis was that supervisors could not always trust the information presented in bank balance sheets. Banks often used different and undisclosed methodologies and assumptions for valuation, provisioning and risk weighting, increasing the opacity and reducing comparability for end users. This added to uncertainty at the height of the crisis and frustrated investors who tried to assess banks' performance and risk. We are considering if we could usefully look at the range of conditions and practices that affect supervisory judgment about loan loss recognition, reserves, provisioning and valuation in the banking and trading book.
- Finally, we are thinking about management practices within supervisory agencies. Supervisors do not always set clear time-bound expectations for the impact that they expect supervisory action to have on bank behavior – such as actions they might take to halt a general decline in underwriting standards or to mitigate a rise in the risks associated with cyber security.

This is related to the transparency of supervisory practices which is a difficult topic for at least three reasons: it is hard to prove a problem has been averted; it is hard to be consistent through the economic cycle; and it is important for there to be an open dialogue between banks and their supervisors and, for this to work, supervisors have to be alert to how and indeed whether they reveal commercially sensitive information. We are framing up a possible range of practices study in this area to establish a base-line for strengthening this aspect of international supervisory practices.

Implementation

Let me now switch gears to implementation. This is an important conference topic for a couple of reasons. How supervisory authorities are actually implementing the Basel standards will influence the business and rules environment within which operational risks are managed. And, secondly, I would like to counter what I think is a fairly widespread misperception that the implementation of Basel III is in trouble.

The truth is, we are making solid progress. And, while there are difficult open issues with which we must contend, there is every reason to think that the institutional arrangements we have at the Basel Committee will be able to rise to the challenge.

The transitional phase for Basel III phase in began on 1.1.13. Most provisions are expected to be phased in by 2018. Twelve of the 27 Basel Committee members have issued their final set of regulations. The other 15 have issued drafts.

It is especially important that the jurisdictions that are home supervisors to G-SIBs finalize their regulations as soon as possible. That includes the United States and Europe. Both jurisdictions are working diligently to that end. As you may know, the European Commission announced a short while ago that it had completed its discussions with the Council of Ministers and the European Parliament and that they confidently expect to have a final rule translated and in place in a matter of months. And, likewise, here in the United States, the three banking agencies are even now working diligently to resolve outstanding issues and to issue a final capital rule as soon as we can.

To facilitate proper implementation and follow up, the Basel Committee has begun monitoring the consistency of jurisdictions' rules and the Basel standards. In 2012, the Regulatory Consistency Assessment Program or RCAP was launched with assessments of the United States and European draft rules and the Japanese final rules.

We have just completed a final rule assessment of Singapore and assessments are underway for Switzerland and China. Assessments of Australia and Brazil and follow up assessments of the United States and Europe once their final rules are completed are also in the planning stages. The aim is to have completed assessments of the great majority of the Basel Committee members by the end of 2014.

In the case of Japan and Singapore, there were no material differences between their national rules texts and the Basel standards. Singapore, for example, was “largely compliant” on credit risk for the internal ratings based and the standardized approaches but was “compliant” on all the other key components of the Basel framework, including operational risk for all three approaches, the Basic indicator, Standardized and Advanced Approaches.

In Europe, the Committee judged that there were material deviations in the definitions of capital and the internal ratings based approaches. In the United States, material differences were confined to securities-related regulation – in particular the restrictions on the use of credit ratings required by the Dodd-Frank Act. But otherwise, the draft rules key components of the local implementation of the framework in both jurisdictions were largely or fully compliant.

These assessments ask two rather formal questions – are there local rules? And if there are, how closely do the texts of the rules conform to the Basel standards? Useful as this information is, the questions we are really interested in from the point of view of global financial stability are:

- How much variation is there in the effect of national rules in the way that banks and regulators calculate their capital? And
- How far advanced are we in recapitalizing the global banking system?

The Committee has tackled the first question by conducting two studies of risk weighted asset calculations in global banks, one for the banking book and one for the trading book. The preliminary trading book study was published in January and the preliminary banking book study is on schedule to be published this spring.

What the trading book study and the preliminary banking book results show is considerable variation across the sample of banks used, between the banks that are most and least conservative in their estimates.

In the trading book, part of this variation appears to be due to differences in modeling assumptions and parameter choices. So for example, the rules allow national jurisdictions to give banks latitude to choose the period over which data is collected for calculating VAR in the trading book. This can be as short as a year or as long as five years. Today, a bank using a five year time series will just be capturing the extreme volatility of the crisis period, whereas any shorter period is likely to yield a VAR estimate that is much smaller.

The Committee has begun a review of the scope for tightening up details of the framework to reduce such sources of variation.

The second question has been tackled by a series of quantitative assessment studies. The Basel Committee has just published – or it is just about to publish – a study based on 2012 data of a sample of 210 banks across the globe. Coverage of larger banks in this sample is pretty much 100%. This study shows consistent declines in the shortfall of actual capital as measured between actual capital and the amount of capital that would be required to be fully compliant with the fully phased in Basel III

standards. So, for example, so-called Group 1 banks (banks with over Euros 3bn in Tier 1 capital that are internationally active) had in June 2012 a combined shortfall of about Euros 400bn in common equity tier 1 capital, plus the G-SIG surcharge, plus the capital conservation buffer, compared with Euros 600 billion six months earlier and about Euros 700 billion a year earlier.

There are of course areas facing difficulties, but I think overall implementation progress is very solid whether the measure is formal adoption of the Basel framework, the effect of the framework, or the level of capital in the global banking system.

In conclusion, we are entering a period globally where our priorities are being rebalanced between rulemaking on the one hand and supervision and implementation on the other. Both supervision and implementation pose serious challenges, but the Basel Committee, and more importantly, their member countries, are making considerable progress in making the global banking system more safe and more sound going forward.

Thank you.