Basel Committee
on Banking Supervision

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Two truths and a myth in banking regulation

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Introduction

Good morning, and thank you for inviting me to speak at this Eurofi High Level Seminar. It's a pleasure to be in Ghent with you today.

Throughout the years, there has been no shortage of discussions at these Eurofi events about the work of the Basel Committee, and prudential regulation and supervision more generally. Take a cursory look back at previous conferences, and you will stumble upon sessions with titles such as:

- "Impacts of Basel III on EU financial activities";[1]
- "Implementing Basel III in the EU: remaining challenges and timing";[2]
- "Basel III implementation in the EU: key political stakes";[3] and, as part of this week's event,
- "Basel III implementation: global consistency challenges"[4].

You would be forgiven for wondering whether we are in some sort of Basel III implementation Groundhog Day! In fact, Basel Committee member jurisdictions are making good progress with implementing the outstanding Basel III standards. Around a third of members have implemented all, or the majority of, the standards already, while two thirds plan to implement them by the end of this year. Most of the remaining jurisdictions expect to implement the outstanding standards by next year.[5]

But it is also true that discussions around Basel III – including at these events – are often dominated by somewhat flimsy assertions. Many have been warning about the detrimental impact of Basel III for almost 15 years now. Yet the empirical evidence to date is overwhelmingly clear: the

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[1] Eurofi (2019).
[2] Eurofi (2021).
[3] Eurofi (2022).
[4] Eurofi (2024).
[5] BCBS (2023b).

global banking system has become more resilient since the implementation of Basel III, and bank lending has expanded in most jurisdictions during this time period.[6]

So we could all benefit from a reminder about why the Basel III standards are critical to safeguarding the resilience of the global banking system and supporting economic growth and the prosperity of households and businesses. I will therefore take a step back today to underline two recurring truths and to debunk a recurring myth when it comes to bank regulation and supervision.

Truth number 1: banking crises have a profound impact

The history of banking crises is rich and deep. Since 1920, the average share of countries around the world experiencing a systemic banking crisis in any given year is about 7%.[7] There have been over 150 systemic banking crises around the globe since 1970.[8] The Committee itself, which celebrates its 50th anniversary this year, was established in the aftermath of a series of banking crises in 1974.[9]

Systemic banking crises have a profound impact on our economies and social welfare.[10] Banking crises have historically led to a persistent loss in output to the tune of 10% of GDP.[11] Banking crisis-induced recessions permanently depress the level of output, with typically no return to pre-crisis trends.[12]

If this sounds like ancient history, then recall that it was less than a year ago when we witnessed the most significant system-wide banking stress since the Great Financial Crisis in terms of scale and scope.[13] Over the span of a few days and weeks, five banks with total assets exceeding $1.1 trillion were shut down, put into receivership or rescued. The distress of these banks triggered a broader assessment of the resilience of the broader banking system.

In response, large-scale public support measures were deployed by some jurisdictions to mitigate the impact of the stress. A back-of-the-envelope estimate suggests that roughly $500 billion of direct public support was provided in response to the turmoil.[14] That's a large number!

So what does the history of banking crises tell us about the future? Forecasting is a notoriously imprecise science; the economist Ezra Solomon once quipped that "the only function

[6] BCBS (2022).
[7] See Reinhart and Rogoff (2009). The cited figure is the simple average of the two-year average share of countries with systemic banking crises.
[8] See Laeven and Valencia (2018).
[9] Hernández de Cos (2019).
[10] See, for example, Claessens et al (2012), Jordà et al (2013), Jordà et al (2015) and Aikman et al (2022).
[11] Cerra and Saxena (2008).
[12] Cerra and Saxena (2017).
[13] BCBS (2023c).
[14] Based on a best-efforts calculation, using public data, of the amount of support provided/pledged through: (i) government guarantees; (ii) central bank emergency liquidity provision; (iii) central bank funding schemes; and (iv) central bank FX swap lines.

of economic forecasting is to make astrology look respectable".[15] Notwithstanding that word of caution, we can be fairly confident in saying that crises are a quasi-inevitability of a banking system model premised around the use of leverage and maturity transformation. But we have a choice to make as to how frequent and severe such crises may be in the future.

The Basel Framework is not designed to produce a "zero failure" banking system, but rather to reduce the likelihood and impact of banking stress, while facilitating financial intermediation and economic growth. Attempts to weaken the framework will only aggravate the impact of future crises.

And yet, despite the painful experiences of the many past banking crises, history suggests that the lessons from such events can sometimes be forgotten as part of a so-called "regulatory cycle".[16] Memories of banking crises fade, whether because of the mere passage of time or due to later events.[17] Vested interests start to gain momentum, and the fallacy of "this time is different" reoccurs. This tests our will to persevere with the implementation of post-crisis reforms. We convince ourselves that some reforms may no longer be needed or warranted, or even that rolling back reforms may be the key to achieving other short-term economic objectives. This is a path that we must collectively resist.

Each banking crisis has its own distinct features and specificities. All healthy banks are alike, while each distressed bank is distressed in its own way, to paraphrase Leo Tolstoy.[18] But there is one recurring theme throughout crises: it is strong and healthy banks that are able to withstand crises and continue to lend. That, in turns, requires having robust regulation and strong supervision as a foundation, and that we draw the lessons from each crisis. This is why, in response to last year's banking turmoil, the Committee is prioritising work to strengthen supervisory effectiveness and identifying issues that could merit additional guidance at a global level.[19]

Truth number 2: finance and banking are always evolving

The banking system has historically always evolved and adapted in response to structural changes.[20] Discussions today about the use of artificial intelligence and machine learning in banking are a far cry from the Babylonian financial system.[21] Indeed, we are witnessing profound transformations – and with them potential risks and vulnerabilities – to the global banking system. Let me mention three such examples.

The first is the ongoing digitalisation of finance. Finance and technology have a long and symbiotic relationship.[22] Yet the most recent technological breakthroughs in payment systems, digital banking services and data analytics stand out for their pace and scale. The very definitions of "banking" and what a "bank" is are being put to the test because of these technological

[15] Zeikel (1991).
[16] Carstens (2019).
[17] See, for example Thorndike (1914) and Underwood (1957).
[18] Tolstoy (1878).
[19] BCBS (2023b).
[20] Grossman (2010).
[21] Bromberg (1942).
[22] Hernández de Cos (2022b).

innovations. The use of ever more digitalised banking services – which can in principle be beneficial – presents its own set of risks to banks. Digitalisation may also increase the interconnections across different sectors and nodes of the global financial system. This is why the Committee will publish a report in the coming months on the bank and supervisory implications of the digitalisation of banking.

A second example is the financial risks stemming from climate change. It is now generally accepted that climate change may result in physical and transition risks that could undermine the safety and soundness of individual banks, and have broader financial stability implications. Banks worldwide are potentially exposed to such risks regardless of their size, complexity or business model. Against that backdrop, the Committee is pursuing a holistic approach to mitigate climate-related financial risks to the banking system, spanning the three Basel pillars of disclosure, supervision and regulation.[23]

Third, non-bank financial intermediation (NBFI) has grown significantly since the Great Financial Crisis, and now encompasses nearly half of total global financial assets. While the Committee focuses on the global banking system, the growth in NBFI is important, given the interconnections between banks and non-bank financial intermediaries.[24] Events over the past three years, including the market turmoil in March 2020, idiosyncratic episodes of NBFI distress and margin dynamics have highlighted how these channels of interconnections can pose risks to banks. Against this backdrop, the Committee will be consulting on updated supervisory guidance with regard to NBFI risk management over the course of this year.

Yet despite these structural developments, we cannot lose sight of the fundamentals of banking supervision. The Committee's Core Principles for Effective Banking Supervision provide a de facto minimum standard for the sound prudential regulation and supervision of banks worldwide. Indeed, they are universally applicable and accommodate a range of banking systems and a broad spectrum of banks. The Core Principles are intended to be a "living" standard that evolves over time in response to global financial developments. This is why the Committee consulted last year on revising the Core Principles to reflect the evolution of risks and vulnerabilities affecting the banking system.[25] I expect that we will finalise these updates over the coming months.

Myth: now is not the "right" time to implement reforms

And now, the persistent myth. Since the Committee launched its Basel III reforms in late 2008, we have repeatedly heard assertions along the lines of "now is not the right time to implement Basel III" due to "unique" and "exceptional" circumstances. The list of arguments provided over the past 15 years has continued to grow and includes economic headwinds – including both the "low-for-long" and "high(er)-for-long" interest rate environment – national elections, the pandemic, geopolitical developments and, perhaps most ironically, concerns about the frailty of banks.

[23] Hernández de Cos (2022a).
[24] Hernández de Cos (2023).
[25] BCBS (2023a).

Yet the truth is that waiting for the "ideal" time to implement Basel III is like waiting for Godot. To be clear, there is of course a need to ensure that authorities and banks have enough time to transpose and implement the standards. This is why the Committee included generous phase-in arrangements for each set of Basel III standards: nine years for the initial set of reforms, and a further 11 for the subsequent ones. And we have been pragmatic as well, for example by deferring the implementation of some of the Basel III standards in response to the Covid-19 pandemic. In total, it will be 20 years since the Great Financial Crisis by the time the last element of the outstanding Basel III standards is expected to be implemented in 2028. Banks have surely had more than enough time to shore up their resilience through retained earnings, building liquidity buffers and making other portfolio and strategic adjustments.

Consider the counterfactual scenario where no aspects of Basel III had been implemented thus far. Banks would have operated with wafer-thin capital, with leverage ratios for some banks teetering at under 1.4%, and acute maturity mismatches. How would the global banking system have fared in response to the various shocks that we witnessed over the years with such high levels of leverage? How many banks would have failed, or would have required further taxpayer support, were it not for the enhanced resilience delivered by Basel III? How severe would the accompanying credit crunch and impact on jobs have been? There are clearly no definitive responses to these questions, but we can be fairly confident in assuming that the global banking system would have been in a much more dire situation.

In fact, the evidence is now increasingly clear that the outstanding Basel III reforms will complement the previous reforms in having a positive net impact on the economy, including in Europe.[26] For example, a recent analysis by the ECB suggests that the GDP costs of implementing these reforms in Europe are modest and temporary, whereas their benefits will help permanently strengthen the resilience of the economy to adverse shocks.[27] The benefits also extend to banks' own private gains. Empirical work suggests that there is a tight link between the profitability, valuation and resilience of banks, with price-to-book ratios positively associated with banks' capital buffers.[28]

I would be remiss if I did not try to counter a related myth about bank capital. Bank capital is not idle money that banks hold or that is is "set aside…or locked away in a vault".[29] It is quite simply a source of funding akin to others that can be used for lending, trading and other activities.[30] And let´s also stress the existing empirical evidence that finds a strong association between higher bank capital and a lower debt financing cost.[31]

But the job is not done. It is critical that member jurisdictions implement the outstanding Basel III standards in full and consistently, and as soon as possible. Many have already done so, and are benefiting from the increased resilience of their banking systems. The fault lines that these reforms seek to address remain as material today as they did seven years ago. This is why the

[26] BCBS (2010, 2019, 2021).

[27] Budnik et al (2021).

[28] Caparusso et al (2023).

[29] Admati et al (2024).

[30] Ibid.

[31] Gambacorta and Shin (2018).

Committee will continue with its Regulatory Consistency Assessment Programme over the coming years to assess the implementation of these standards at a jurisdictional level.

Conclusion

Regulators are often accused of fighting the last war. Yet in the case of implementing Basel III, it is the dragging on of the process – with attempts to reopen past reforms and battles – that will divert important resources from banks and supervisors to deal with current and emerging risks instead. We owe it to our citizens to lock in the financial stability benefits of Basel III and, in parallel, to ensure that we are able to identify and mitigate new risks so that our mandate to safeguard global financial stability is fulfilled at all times.

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