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Regulation and supervision since the Great Financial Crisis: developments and future challenges*

Closing remarks at the presentation of the book *Regulación y crisis bancarias recientes*

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*English translation of the original in Spanish

Good afternoon.

I would like to thank CUNEF Universidad for inviting me to the presentation of Francisco Uría's book *Regulación y crisis bancarias recientes. Reflexiones y retos futuros*. The string of crises over the last few years has presented the financial system with its first major stress test since the Great Financial Crisis.

All of the regulatory and supervisory advances made since that crisis, and above all the cultural shifts in risk management that it prompted, have put our financial system on a sounder footing.

In my address today I will briefly outline the regulatory headway of recent years, drawing parallels with the lessons learned from the turmoil of this year. I will also review the progress made in Europe by virtue of the banking union and, lastly, I will touch on the challenges that lie ahead, after recent events underscored the need to maintain a proactive approach to regulation and supervision.

Reforms in the aftermath of the Great Financial Crisis and parallels with the recent turmoil

As the book describes, the Great Financial Crisis brought with it the need to overhaul the global regulatory and supervisory framework. The shortcomings identified showed that the problems could have been addressed through reinforced regulation, more effective supervision and better risk management and governance by banks. The reforms focused on four areas: (1) increasing the resilience of financial institutions, with enhanced risk measurement, control and management; (2) addressing the problem of too-big-to-fail banks; (3) strengthening the derivatives markets; and (4) efforts to control the shadow banking sector, now better known as non-bank financial intermediation (NBFI).

On the first point, the Basel III reform package[1] made significant progress towards standardising international regulations. These reforms introduced higher minimum capital requirements, enhancing the design and definition of the capital ratio numerator and raising the proportion of common equity Tier 1 capital. The aim was to improve banks' going-concern loss-absorbing capacity. The rules for calculating the ratio's denominator (risk-weighted assets) were also revised for better comparability and risk measurement. In addition to these improvements to the capital adequacy ratio, the reforms sought to address other problems by including a series of additional requirements, such as a globally consistent leverage ratio, two liquidity ratios (one short-term and the other long-term) and large exposure limits, as well as introducing a macroprudential focus. Lastly, the Basel Committee on Banking Supervision (BCBS) issued a number of supervisory guidelines and principles.

Although the changes introduced by Basel III are well known, I would like to recap some of them as a reminder that the tools needed to contend with the problems affecting the banking sector – some of them closely linked with the recent banking turmoil – are already available.

I would like to begin with **governance**. Perhaps the main lesson from the turmoil this year is that the first and most important source of financial and operational resilience comes from

[1] Pablo Hernández de Cos. (2019). "International banking regulation reform and current and future challenges".

banks' own risk management practices and governance arrangements. The turmoil highlighted important shortcomings in the management of traditional banking risks (including interest rate risk and liquidity risk), high levels of concentration risk, inadequate and unsustainable business models, a poor risk culture and ineffective senior management and board oversight. Lastly, banks failed to adequately respond to supervisory feedback and recommendations.[2]

The turmoil arose despite the significant international progress made in the wake of the Great Financial Crisis. For instance, back in 2012 the BCBS agreed the Core Principles for Effective Banking Supervision,[3] which set out a framework to ensure robust and transparent risk management and decision-making by banks. It also recognised that these principles should be applied commensurately with the size, complexity, structure, economic significance, risk profile and business model of each bank and, where applicable, its parent group. This allowed for some proportionality in the adoption of these principles.

Of the corporate governance principles published in 2015,[4] I would like to single out the seventh. This principle states that a bank's internal risk governance framework should include policies supported by appropriate control procedures and processes designed to ensure that the bank's risk identification, aggregation, mitigation and monitoring capabilities are commensurate with its size, complexity and risk profile. This control framework should encompass each and every material risk to the bank on a group-wide, portfolio-wide and business-line level. It also stipulates that banks should utilise stress tests and scenario analyses to better understand potential risk exposures under a variety of adverse circumstances. Lastly, special attention should be given to the data used for decision-making. One of the main lessons learned from the Great Financial Crisis was that banks' information technology and data architectures were inadequate to support the broad management of financial risks. In response, in 2015 the BCBS issued its Principles for effective risk data aggregation and risk reporting.

Reading these principles is a reminder that banks should appropriately manage risks by using forward-looking risk assessments based on different scenarios. The banks that collapsed this year failed to manage their balance sheet imbalances at a time when the built-up vulnerabilities were being compounded by the rapid increase in interest rates. Social networks were not the root cause of the problem, but they did exacerbate the banks' business model vulnerabilities and inadequate risk management.

Second, I would like to discuss the **Basel III framework's scope of application**. The current standards are intended as a set of global requirements for 'internationally active banks'. However, that term has not been defined, which provides jurisdictions with flexibility to determine the scope of application of the Basel standards. As such, authorities can apply the standards either to the entire banking sector, as we do in Europe, or to a subgroup of banks only. Regardless of which approach is adopted, the Basel Core Principles for Effective Banking Supervision state that, as a rule, banks should be subject to supervision commensurate with their risk profile and systemic importance.

[2] BCBS. (2023). "Report on the 2023 banking turmoil".

[3] https://www.bis.org/publ/bcbs230.pdf

[4] https://www.bis.org/bcbs/publ/d328.pdf

Again, as the recent turmoil has shown, a bank's failure can have systemic implications through multiple channels. For instance, a crisis at a bank deemed not to be internationally active, and therefore not subject to Basel III, could trigger broader turmoil simply by contagion through, for instance, a liquidity or confidence crisis in financial markets.

Third, and related to this point, I would like to discuss the **liquidity requirements** introduced by Basel III in the wake of the Great Financial Crisis. In 2008, the BCBS published its Principles for Sound Liquidity Risk Management and Supervision. Two further minimum requirements, with separate but complementary objectives, were subsequently added. The first, the liquidity coverage ratio (LCR), was designed to improve banks' resilience to liquidity shocks lasting 30 days. The second, the Net Stable Funding Ratio (NSFR), was intended to foster resilience over a longer time horizon (one year), to create further incentives for more stable funding.

Some of the turmoil this year might have served to test the effectiveness of these ratios. However, most of the failed banks were not subject to them.

This is a reminder that more thought should be given to the scope of international standards. However, these events have provided material information to test the ratios' design and calibration in real-world scenarios. For instance, deposit outflow rates turned out to be larger than estimated in the ratio calibrations, as a result of social media influence, digitalisation and concentration.

One bank that the liquidity requirements did apply to was Credit Suisse. According to the BCBS report, Credit Suisse was of the view that use of its short-term liquidity buffer would constitute breaches of Pillar 1 or Pillar 2 requirements, which would need to be disclosed to the markets, possibly affecting its willingness to draw down this buffer as envisaged in Basel III. The BCBS is currently evaluating the functioning of the liquidity standards to consider, among other aspects, whether the LCR calculation should be adjusted to capture the short-term liquidity situation.

The last point I would like to address is the framework for **interest rate risk on the banking book**. In the wake of the Great Financial Crisis, the BCBS agreed to revise the principles for the management of interest rate risk to reflect existing practices. Again, Pillar 2 was not applicable to the US banks that failed this year, although interest rate risk concentration was observed at those banks. This leads us to reflect once again on the scope of application. Yet there are other areas of debate, such as the suitability of using Pillar 2 versus the standardisation that could be achieved via Pillar 1. This is something that was weighed up in 2015 but on which there was no consensus.

With this recap, I hoped to highlight the robustness of the international standards from multiple angles. The regulatory and supervisory framework should always be examined for any unwanted consequences. That said, the crises observed and the **lessons learned do not suggest that a drastic change in our current regulatory framework is needed**. Going forward the BCBS will instead focus on how to make supervision more effective, identifying the possible areas where additional international guidelines may be needed.

In addition, more empirical evidence-based analytical work will be conducted to evaluate the functioning of the Basel framework and assess whether any adjustments are necessary in the medium term.

This future work is in complete alignment with the imperative to ensure full and consistent implementation of the international standards as soon as possible to safeguard global financial stability.

The changes were far-reaching in Europe, via the creation of the banking union ...

In this second section of my address, I would like to mention the far-reaching changes made to the European supervisory framework. By that I mean the banking union, whose key components are: the single rulebook, the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the European Deposit Insurance Scheme (EDIS).[5]

The **single rulebook** transposes Basel III – with the capital, liquidity and governance requirements for banks – into European legislation, and also includes depositor protection and the regulation to prevent and manage bank failures. It is applied effectively and consistently across the euro area and makes banks more transparent, resilient and efficient.

The **SSM** is the European banking supervisory authority, comprising the European Central Bank and the national authorities tasked with supervising the 110 largest euro area banks. The SSM verifies compliance with regulations and applies consistent supervisory criteria and methodologies. The supervisory approach is risk-based, i.e. the risks specific to each bank come under the spotlight, but the starting point is a general framework for the risks and vulnerabilities facing the sector as a whole. The macroeconomic environment in which banks operate is also considered. Supervisory priorities and the corresponding supervisory activities are established so as to assess the main risks to which banks are exposed, analyse how they are managed and, as appropriate, impose measures to remedy the shortcomings detected.

The **SRM**, comprising the Single Resolution Board (SRB) and the Single Resolution Fund (SRF), provides a common framework to resolve failing banks. The SRF, built up by contributions from banks, is earmarked for helping bail in or wind up problem banks, thereby alleviating the burden on taxpayers.

The banking union's final pillar (the EDIS), to guarantee European citizens' deposits wherever they may be, is incomplete. Although deposits are currently protected by strengthened guarantee schemes, work must continue to create this unified scheme. It is the missing link to complete the banking union.

The future still holds risks that we must continue to monitor and address ...

Nevertheless, European banks are now stronger, meaning we are better placed to tackle the current challenges, such as steering funding towards a more sustainable and digital economy. Regulation and supervision must maintain a forward-looking approach to these future challenges, which are already beginning to have consequences in the present. This forward-looking approach is especially important not only for assessing the banking sector's solvency and liquidity, but also for analysing how banks' business models are adapting to the new, uncertain and changing environments. This is all the more important in the current setting in which new actors, products and technologies are bursting into the

[5] Margarita Delgado. (2023). "The banking union: what is it and how does it benefit us?". Banco de España Blog.

financial ecosystem. As regulators and supervisors we will have to incorporate sufficient flexibility and responsiveness into our respective areas of competence to duly meet our objectives. Tools such as scenario analysis and stress tests are very important, as they can be adapted to different structural and cyclical risks and to different time horizons.

We live in unpredictable and rapidly changing times. Banks, supervisors and regulators alike must act flexibly to adapt to the changing circumstances. First, banks must analyse and adapt their business models, appropriately managing both traditional and emergent risks to ensure their own survival. Second, the authorities must also review their criteria, methodologies and procedures to serve the new supervisory and regulatory needs with the nimbleness and flexibility that this new age demands. Specifically, supervision must focus primarily on the specific risks to which banks are subject and, of course, supervisors must have effective tools to impose tailored corrective measures commensurate with the gravity of the weaknesses detected, in order to mitigate and remedy them.

Conclusion

As you can see, regulation and supervision have moved with the times based on the needs and shortcomings detected in the successive crises. It is important we all reflect and learn lessons from past episodes to bolster the framework within which the financial system operates, which is key to the smooth functioning of the real economy and, therefore, growth. In addition, we must be watchful of all the changes taking place around us to ensure that all the cogs – traditional financial institutions, the new technological ecosystems and regulators and supervisors – function efficiently and ensure the necessary financial stability, which is our ultimate objective.