

Where next for the Basel Committee?

Pablo Hernández de Cos

Chair of the Basel Committee on Banking Supervision and Governor of the Bank of Spain

Keynote speech at the Eurofi High-level Seminar 2023

Stockholm, 28 April 2023

Introduction

Good morning, and thank you for inviting me to speak at this High-level Seminar.

In many ways, the recent banking turmoil was the first “real” stress test of the banking system (or at least parts of it) since the Great Financial Crisis; as the banking system benefited from the huge scale of public support measures during the Covid-19 pandemic. We can take some comfort that the significant increase in financial resilience, due in large part to the Basel III reforms, has served to safeguard the stability of the global banking system. But we should also recognise that, once again, significant public sector intervention was needed to avoid potentially adverse spillovers to other banks, non-bank financial intermediation (NBFIs) entities, and ultimately the real economy. With that in mind, we need to remain focused on assessing and mitigating the risks and vulnerabilities affecting the global banking system. These include elevated debt levels and stretched asset valuations, geopolitical developments, complex and opaque bank interconnections with NBFIs entities, and continued uncertainty with regard to economic growth, inflation and interest rate dynamics.

Against that backdrop, I will be taking a step back today and reviewing the work programme and strategic priorities of the Basel Committee for 2023–24.¹ There are five broad themes that I will cover today – all of which have a bearing, directly or indirectly, on the recent banking turmoil and the short- to medium-term risks for the global banking system. But let me give you the headline messages upfront:

- there is a wide range of both short-term risks and medium-term structural changes that are testing and will continue to test the resilience of the global banking system;
- now is not the time for complacency or regulatory rollbacks; and
- safeguarding financial stability requires global cooperation more than ever.

¹ BCBS (2022a).

Emerging risks and horizon-scanning

The first theme of the Committee's work programme relates to emerging risks. The Committee will continue to pursue a forward-looking approach to identifying and analysing risks and vulnerabilities to the banking system. This includes the impact of ongoing geopolitical developments, stagflationary dynamics, scarring effects from recent crises and cross-border spillovers to banking systems.

The Committee is also reviewing the recent banking turmoil and will take stock of the regulatory and supervisory implications from recent events, with a view to learning lessons. I recently set out my initial reflections about implications of these events for banks, supervisors and regulators.² I don't plan on repeating these remarks today, but I will sum them up in three points.

First, even in 2023, we continue to see cases of banks that fail to meet basic risk management and governance practices. The boards and management of banks should be the first port of call in managing and overseeing risks; these functions cannot be outsourced to supervisors. Second, it is crucial that we work collectively in preserving the strength and robustness of supervision over time. Supervisors must be able to exercise their judgment and tell banks, for example, that their leverage or maturity transformation are too elevated, and that they should promptly and substantively remedy risk management and governance failings. Third, we must remain acutely aware of the dangers of the "regulatory cycle", where memories of banking crises fade over time and vested interests call for regulatory rollbacks, all of which risk a weakening of the financial system. To that end, it is important to keep an open mind at this stage about whether any potential revisions to the global regulatory and supervisory framework are needed. And of course, the implementation of agreed global reforms remains of paramount importance.

In addition to reviewing the recent banking turmoil, the Committee is also conducting a series of horizon-scanning exercises related to other emerging risks and vulnerabilities. This includes work on the bank and supervisory implications of risks related to inflation, as well as risks specific to emerging market economies and cross-border booking models. The Committee will also continue to assess the robustness and suitability of banks' credit risk models, drawing on the lessons learnt from the pandemic and the evolving macro-financial outlook.

Digitalisation of finance

Moving on, the Committee will also be pursuing a wide range of initiatives related to the digitalisation of finance, which include analytical, policy and supervisory-related elements.

Over the coming two years, the Committee will publish an analytical report on the bank and supervisory implications of the ongoing digitalisation of finance. The report will review and synthesise a wide range of technological developments, including the emergence of new entrants/suppliers in the banking system, the use of artificial intelligence and machine learning,

² Hernández de Cos (2023).

big data and governance arrangements. It will also draw on a deep dive analysis under way on the supervisory implications of banking as a service.

The Committee will continue its work related to cryptoassets, following the finalisation of our prudential standard on banks' cryptoasset exposures last year.³ This involves two strands of work. First, the Committee will continue to closely monitor and assess bank-related developments in cryptoasset markets, including the role of banks as potential stablecoin issuers or custodians of cryptoassets, and it will also look at the broader potential channels of interconnections with the cryptoasset ecosystem. Second, it will monitor the implementation of its prudential treatment of banks' cryptoasset exposures. As part of this monitoring, the Committee will review by the end of this year the treatment of permissionless blockchains with additional safeguards and the criteria to identify stablecoins eligible for the "Group 1b" prudential treatment, including the appropriate composition of reserve assets and the effectiveness of statistical tests.

Climate-related financial risks

The third theme of the Committee's work programme is climate-related financial risks, which, together with the digitalisation of finance, are perhaps the most existential medium-term threats to the global banking system. The Committee will continue to pursue a holistic approach in this area. This will include work across all three pillars of regulation, supervision and disclosure.

On regulation, the Committee is undertaking ongoing analytical work to assess the materiality of gaps in the existing Basel framework. This follows the publication last year of responses to frequently asked questions that clarify how climate-related financial risks may be captured in the existing Basel framework.⁴ Building on this work, the Committee will consider whether potential regulatory measures to address climate-related financial risks are needed.

On supervision, the Committee will monitor the implementation of its *Principles for the effective management and supervision of climate-related financial risks*, as published last year.⁵ Building on ongoing work by other global forums (most notably the Financial Stability Board (FSB) and the Network for Greening the Financial System), the Committee will also discuss potential complementary work related to banks' transition planning and the use of climate scenario analyses.

On disclosure, the Committee will continue to coordinate with the International Sustainability Standards Board, and, building on this work, will consult on a Pillar 3 framework by the end of this year.

³ BCBS (2022b).

⁴ BCBS (2022c).

⁵ BCBS (2012).

Monitoring and review of existing standards and guidance

Another theme of our work relates to monitoring and reviewing existing standards and guidance. Let me be clear: this work is not about reopening Basel III. We are instead focused on other aspects of our existing supervisory guidelines and regulatory standards that may require review in the light of recent developments.

I will mention three examples of work in this area. First, the Committee is reviewing its *Core principles for effective banking supervision*. The Core Principles are the de facto minimum standard for the sound prudential regulation and supervision of banks and banking systems. They are used by countries as a benchmark for assessing the quality of their supervisory systems, and are also used by the International Monetary Fund and the World Bank in the context of the Financial Sector Assessment Program. The Committee is reviewing the supervisory insights and structural changes since the previous update to the Core Principles in 2012, and will consult on revisions by mid-2023.

Second, the Committee is reviewing its supervisory guidance and principles with regard to banks' interconnections with NBFIs. The past few years have seen several episodes of NBFIs in distress, which in turn revealed a wide range of direct and indirect interconnections with the banking system. The Committee will update its previous *Sound practices for banks' interactions with highly leveraged institutions*, building on its guidelines on step-in risk and drawing on the lessons learnt from recent NBFIs-related stress events.⁶

Third, the Committee will develop updated supervisory principles on banks' outsourcing practices and their reliance on third- and fourth-party service providers. The principles will supersede previous principles by the Committee on outsourcing, and will complement, and build on, similar work by the FSB under way on outsourcing and third-party risk.⁷

Implementation and evaluation

The last, but certainly not the least, theme of our work is the full, timely and consistent implementation of Basel III.

The recent banking turmoil has again reminded us of the critical importance of prudent and robust regulatory standards for bank capital and liquidity. The implemented Basel III reforms have greatly enhanced the resilience of the global banking system, with total leverage in the banking system halving from about 30x to 15x since 2011. Banks' holdings of liquid assets have more than doubled during this period and now stand at €12.5 trillion. These reforms have helped contain the fallout of the recent banking stress events.

But these events have also highlighted areas of "unfinished business", including as it pertains to the robustness and credibility of banks' reported risk-weighted capital ratios. The Basel

⁶ BCBS (1999) and BCBS (2017).

⁷ BCBS (2005).

III reforms finalised in 2017 seek to address these and other fault lines, which remain as material today as they did six years ago. Therefore, implementing the outstanding Basel III standards in a full and consistent manner in all jurisdictions is a critical step towards safeguarding the resilience of our banking system.

Conclusion

In conclusion, there are no shortages of risks and vulnerabilities affecting the global banking system. Medium-term structural changes raise fundamental questions and challenges for banks and supervisors. The Committee has a wide-ranging and comprehensive work programme in place to address these challenges over the next two years. And, as we have seen with the recent episodes of banking stress, cross-border supervisory cooperation is more important than ever.

References

Basel Committee on Banking Supervision (1999): "Banks' interactions with highly leveraged institutions", January.

——— (2005): "The Joint Forum: Outsourcing in Financial Services", February.

——— (2012): "Core principles for effective banking supervision", September.

——— (2017): "Identification and management of step-in risk", October.

——— (2022a): "Basel Committee work programme and strategic priorities for 2023/24", December.

——— (2022b): "Prudential treatment of cryptoasset exposures", December.

——— (2022c): "Frequently asked questions on climate-related financial risks", December.

Hernández de Cos, P (2023): "Banking starts with banks: initial reflections on recent market stress episodes", keynote speech at the Institute of International Finance Roundtable on the Shifting Risk Landscape, Washington DC, April.