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Hernández de Cos on ECB policy, crises responses and Basel reform

Interview with the Governor, Pablo Hernández de Cos, published in Central Banking

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You took on your role as Bank of Spain governor and member of the European Central Bank's governing council in 2018 – but you had previously attended council meetings and served as adviser to the executive board. During your career, what would you highlight as the most important transformations that have taken place?

I've spent all my life in central banking, at the Bank of Spain or at the European Central Bank. What I've seen over the past two decades is a structural transformation both of the worries that central banks face and the tools they have to face them. At the very beginning of the European Monetary Union, there were some questions about whether it would work adequately. We all wanted to have the anchor of German monetary policy thinking. We succeeded.

And now, of course, we are in a completely different environment. Over the past decade, we have been worried about low inflation, more than the opposite. And we face the challenge of a very low natural interest rate environment, which leads to the effective lower bound of interest rates becoming more binding. These have led us to the expansion of the ECB's monetary policy tools, which was a complete novelty. Indeed now after some years using them, we have to stop calling them unconventional and start considering them conventional monetary policy tools. I would say this is the most important structural transformation that I've experienced.

Do you think the effectiveness of the various unconventional tools implemented over the past decade are well understood as moving interest rates?

It was a learning process for all of us to understand them – including financial markets, the banking sector, non-financial companies and even households. For central bankers, the relative efficiency of the different tools is of course very important. And it´s clear that some tools are more efficient than others. We didn't have much experience before this practical use of them and we are still learning.

On December 10, the Governing Council agreed to increase the pandemic emergency purchase programme's (PEPP) portfolio by €500 billion, and the period of net purchases to March 2022. However, it also said that if favourable financing conditions can be maintained without exhausting the envelope, it "need not be used in full". Does this rule out new increases to the portfolio? Are you concerned markets may interpret this wording as ECB's unwillingness to provide more stimulus?

It is true that there was a novelty in the statement released in December, indicating the PEPP envelope may not be used in full. At the same time, it was also mentioned that the PEPP envelope could indeed be increased, again, if required. Here, the key is to maintain favourable financing conditions. We want to give a signal of efficiency, in the sense that if we are able to maintain favourable financing conditions without using the full envelope, we will do so. But if this is not the case, for whatever reason, and we need to fully use what we have already approved or even to increase it, we are ready to do so as well.

Following this month's meeting, some have pointed out PEPP's extension is increasingly transforming it into a yield-curve control mechanism. Is this a fair assessment? Would you favour the formal adoption of the strategies currently implemented by the Bank of Japan or the Reserve Bank of Australia and target a specific yield limit?

We are still a fair distance from what you would call yield curve control. This is for two main reasons. First, yield curve control requires a commitment to purchase whatever amount necessary to keep yields at the targeted level. The PEPP does not incorporate such a commitment, because the envelope sets the maximum amount of net purchases to be conducted. The envelope may be increased, but that does not mean it can be raised without limit, which is a prerequisite of a pure, totally credible yield control policy. Secondly, yield curve control typically refers to the control of a single yield curve, for instance, the Japanese government bond yield curve, in the case of the Bank of Japan.

In our case, as president [Christine] Lagarde explained after our meeting in December, we define financial conditions in a very holistic way – meaning that we do not look at the yields of any particular issuer or sector, but to a broad set of indicators. That includes, for example, sovereign yields, corporate yields, lending rates to households or to corporates, or even lending flows.

I think yield curve control is an option worth exploring. The experience of these central banks suggests that, if sufficiently credible, yield curve control allows the central bank to achieve a yield curve configuration with a lower amount of actual purchases, hence, enhancing efficiency. It's also true that this strategy would be more complex in the eurozone because we don't have one, but 19 sovereign yield curves. You could still target all 19 curves, but as I noted before, that would require a commitment to flexibly buying as many sovereign bonds of those countries as needed – something that could be challenging from an operational and even a legal perspective.

An alternative would be to target the risk-free yield curve, for example the OIS [overnight index swap] curve in the eurozone. This could be coupled with a flexible use of our asset purchase programme to prevent sovereign yield curves from departing from the risk-free

one to the extent this represents a risk to the smooth transmission of our monetary policy. This strategy would probably deliver similar outcomes. However, it's not something we have discussed yet.

The PEPP has evolved very rapidly over this year. And as you mentioned, it now has a very holistic goal targeting broader financial conditions. Looking beyond the pandemic, could this become the longer-term objective of the programme, in contrast to asset purchasing programme goals linked to the inflation target?

Financial conditions should be taken as an intermediate target. But of course, you shouldn't completely separate the intermediate objective regarding financial conditions from your inflation goal. This interrelation should be taken into account for any of the tools we are using. This means you shouldn't pursue a certain level of financial conditions *per se*, but only to the extent that they are compatible or they lead you to achieving your statutory policy objective. We shouldn't miss this interrelation.

Regarding Targeted Longer Term Refinancing Operations (TLTRO), the governing council increased banks' borrowing capacity from 50% to 55% of their eligible loans. Media reports say Philip Lane had put forward an increase to 60%, but the proposal encountered resistance. Some analysts deem it insufficient and say it could force weaker banks to revert to other funding sources. Is the measure enough for banks to offer adequate financing conditions over the coming year?

We know that a large number of eurozone banks are already at, or close to, their borrowing allowance for the TLTRO III operations. Another observation that is important in this regard is that we also know that for banks to actually use any additional TLTRO funds for lending to the real economy, they must have some unused borrowing allowance; otherwise, they would just use any new funds to pay off pre-existing TLTRO loans. Both observations led the governing council to think that an increase in the TLTRO allowance was warranted from a monetary policy perspective. Of course, if the number of banks at the new limit, or close to it, remains high, it would probably suggest the convenience of a further increase in that limit. But for that we will have to wait and see.

In relation to the PEPP, we've rescaled the programme capacity and extension as deemed necessary given current circumstances. But this is not the end of it– it will depend on the evolution of economy, the evolution of financial conditions, etc. Whether the current envelope is sufficient or not, time will provide us with the evidence we need to reach our conclusions.

One of the central aspects of the ECB's strategy review is the reform of the current inflation target. In August, the Federal Reserve unveiled a new strategy allowing inflation to rise over the target to offset periods below it. The ECB has also recorded many years clearly below its main policy goal. Would you support the adoption of average inflation targeting (AIT) at the ECB? What is wrong with having inflation below 2% if there is no risk of deflation?

Our starting point at the ECB is that we have this definition of price of stability of "below, but close to, 2%". In my view, this can be improved. It doesn't provide a clear objective.

Here, a focal point at 2% is probably much better. It would be a move in the right direction, not only regarding clarification. In the current low natural interest rate environment, having a higher target would provide some additional buffer for nominal interest rates vis-à-vis the lower bound. This helps to explain why it is important not to be anchored to an inflation number that is too low. The probability of a situation emerging where the central banks is more constrained by the effective lower bound is higher. A third issue here is symmetry. I want the central bank to be perceived as symmetric, in the sense that it will react as strongly to inflation overshoots as to undershoots.

It would be important to adopt a new formulation that leaves no doubt about this symmetric nature. With the current wording of below, but close to, 2%, this still can be interpreted in an asymmetric way. It would be important to clarify this concept once and for all. The other key aspect is to define what symmetry means in practice. In my view, it should be interpreted as our determination to achieve symmetric outcomes. This means that if you've been below the target for a while, you should also accept inflation outcomes that are above the target for some time.

Even with a symmetric point target of 2% that it is interpreted in a symmetric way, it is obvious that, even there, frequent encounters with the lower bound would remain a possibility for nominal rates if the interest rate of equilibrium remains as low as it is estimated to be currently. And this would represent an asymmetry in our ability to act and stabilise the economy. I believe this constraint should be acknowledged and reflected in our monetary policy strategy. This is what the new monetary policy of the US Federal Reserve is trying to achieve – the average inflation-targeting element they are incorporating refers explicitly to how the central bank should act in the future following a period of below-target inflation.

Whether we have to incorporate it into the final objective, or simply take it into account when setting our policy and signalling for how long our policy still needs to remain accommodative, is something to be discussed.

Do you have a strong view on how the new inflation target should operate?

My strong view is related to three elements that I deem important. First, we need to clarify the target, and have a number that is understandable for everybody, and on which there are no doubts. Second, we need it to be higher than the current number, if only marginally higher, meaning for example 2%. Third, this target needs to be symmetric, and this symmetry needs to be interpreted as the central bank wanting symmetric outcomes. For me, all this is very relevant in the current context.

Some officials and academics are pointing out that average inflation targeting (AIT) entails policy communication challenges. 'Where would be the new upper limit for inflation? For how long would it be allowed to be over the target?' they ask. Some observers think the Fed has failed to address these questions. Do you think it is necessary to address them in order to better guide markets?

I think it's obvious that being more precise on the parameters of an AIT strategy would make it more transparent – and more effective, because it could guide markets in a more effective and accountable way. But at the same time, we know that fixing all those parameters with

a high degree of precision requires a level of knowledge of the economy, the nature and persistence of future shocks that will hit the economy, the reaction that other policy actors will have... a level of information that unfortunately central banks simply do not have. This would lead me to conclude that a certain degree of flexibility in interpreting this strategy is probably warranted. And also an important point here is that central banks need some time to learn more from their experience with a new monetary strategy. This makes it advisable to postpone a more precise calibration of some of these key parameters.

Some might argue that the Fed's new framework is open to interpretation. Some financial institutions might have a very different view of what it means versus others. And in fact, they could end up with some degree of confusion about what the policy is. The other risk is what we have seen in Japan, where the central bank, often for reasons outside of its control, such as big changes in the global economy, is struggling to hit its targets with credibility. So the strategy also seems to entail some reputational risks. Do you have any thoughts on those particular issues?

When you move to a new strategy, you also have to be credible. It's not simply that you adopt a new definition, or you put a new strategy on the table. It's essential that you are interpreted as willing to achieve the new objective. On the other hand, I've just justified the Fed not being very explicit on some aspects because this requires learning experience, and we lack key information about future shocks and structural parameters of our economies; and we don't know how other (structural or fiscal) policies will be.

All in all, my perception is that even with this vague guidance, markets have correctly internalised the main elements of the Fed's new strategy. Markets are projecting the low interest rate environment will be here for longer than previously thought, even if inflation rises over 2%. Inflation expectations in the US have by and large responded as one would have expected, signalling that market participants understand and believe the Fed's resolve to bring inflation back to its long-run goal and anchor it to that level sustainably.

Another key topic in the strategy review is the role climate change could play in affecting the economy, and therefore central banks' objectives over the long term. Some argue climate change does not belong among central banks' responsibilities, particularly in monetary policy. Where do you stand in this debate? Would you support abandoning the principle of market neutrality in asset purchase programmes, as has been advocated by other governing council members?

It's pretty obvious to all of us that climate change is one of the key challenges that our world is facing. In our strategy review, we are just starting to analyse it. Right now, our knowledge is very limited, and it's too early to draw conclusions. It's not the case that I want to eschew the question, simply I want to reflect more on it.

What is obvious is that, to the extent that climate risks affect the economy, the inflation outlook or even the transmission of our monetary policy, then our strategic reformulation should somewhat address it. How should we do it? And what will be the final outcome? To answer these questions, I want to learn more about it. I have to confess this is a new element, a new dimension, on which I still need to see all the analyses that the staff is producing before having a strong position on it.

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We know that the main policy to fight against climate change is fiscal policy. Governments have the democratic mandate to carry out these policies. And we also know that is the most efficient way. Without this, climate goals cannot be reached. Other authorities, including central banks, can only complement fiscal policy. They cannot substitute it. We know there is a need for investment to make this transformation of the economy possible. Does this mean other policies cannot help? No, I think they can. For example, in terms of the role of financial institutions, it’s absolutely crucial that they account for climate-related risks, such as transition risks. We have a responsibility to make sure banks and financial institutions acknowledge this risk today.

Given rising fiscal dominance and a sense of monetary financing in all but name, some argue that Western nations would be better off abandoning the idea of central bank ‘independence’ and adopt a ‘whole-of-government’ response to current and future challenges, including demographic, climate, geopolitical, etc. What is your view?

Monetary policy, price stability decisions, should continue to be adopted by independent institutions. It should be beyond any dispute, and should continue to be a key pillar in any institutional architecture. The main argument supporting this approach is to better serve the public interest. The fact that monetary policy decisions are taken by independent institutions is crucial to the credibility of these decisions, away from the short-term considerations of the government fiscal authorities. We count on a solid theoretical body supporting this view, and, more importantly, we have plenty of empirical evidence showing the positive role that independent central banks have played in achieving price stability. I find no reason to abandon this institutional framework.

The idea that we approaching fiscal dominance originates from an optic illusion: in current conditions monetary policy and fiscal policy are supporting the economy while both being faithful to their respective mandates. For what we are concerned, it is the threat to our objective of price stability that calls for supportive policies, not any attempt to support fiscal policy unconditionally.

But the lines seem to be blurring. How does one defend the importance of independence as those lines blur? Is it even more important, or is it a sense that there is dominance coming through and monetary authorities are constrained in what they can do?

I prefer to put it in a different way. An independent central bank should not be indifferent to challenges such as climate change, demographic shifts and geopolitical trends. On the contrary, those challenges and the political response to them will affect macro-financial developments, and the risks we are facing. As a result, they will also affect monetary policy. When I referred earlier to the reduction of the natural interest rate, one of the main considerations researchers have highlighted when analysing the drivers behind its reduction is demographics. The other is low productivity growth. It’s important that we incorporate these issues into our discussions, and this is why the ECB is taking this broad perspective in our strategy review. We are trying to incorporate all these structural considerations into

our thinking. Nonetheless, attention to all these aspects should be compatible with our price stability mandate.

The effectiveness of an independent central bank in meeting its objective is not unrelated to the circumstances in which it operates. With the pandemic, high public debt will become one of the main elements of concern. And this is why the Bank of Spain has always been vocal in saying monetary policy must be accompanied by sound fiscal policies and structural reforms consistent with economic stability. This is particularly important in the context of a monetary union.

During the long recovery from the global financial crisis, we repeatedly made the point that monetary policy shouldn't be the only game in town. We've defended fiscal policy playing a key role to fight against the current crisis. We have been making the point that not only domestic fiscal policy, but also fiscal policy at the European level should play a key role in fighting the crisis. To a great extent, both the European Council and individual governments have done a tremendous job in this regard. And once the crisis is over, we will have to come back to the idea of making sure public debt is sustainable. Both the defence of a proactive fiscal policy to tackle the crisis today, and in the future the need for fiscal consolidation, are all very relevant from a monetary policy perspective.

This is why the governance structure of the European Monetary Union was accompanied by the Stability and Growth Pact, and later with a macro-imbalances procedure, because fiscal sustainability is absolutely crucial for monetary policy to play its role.

In July, EU leaders took an unprecedented decision agreeing on the €750 billion Next Generation EU fund, with the European Commission raising funds in the market. How do you value this new mechanism? If it became permanent, do you think it would be better at addressing fragmentation risks than the ECB's asset purchases?

This is a crucial step in European integration. There are several important elements in the Next Generation EU fund. First, the magnitude (€750 billion) is very relevant. Secondly, the funds' distribution is close to 50-50 between transfers and debt instruments. And most importantly, it will be financed by the European Union's debt. And the funds prioritise regions where they are more needed. These elements are crucial. But I should also emphasise the important limitation: it doesn´t solve the lack of a permanent macroeconomic stabilisation mechanism.

All monetary unions have some sort of fiscal stabilisation mechanism. Either automatic, for example an unemployment insurance scheme common to all countries, or discretionary. We know that, depending on the magnitude of the crisis, it is not enough to have an automatic stabilisation mechanism – on top of it, you may also need some discretionary funds to be used in order to stabilise the economy and to help monetary policy in this endeavour of stabilising the economy. In this regard, it's absolutely crucial that the Next Generation EU fund becomes the origin of a more permanent capacity in the future.

Also, for monetary policy purposes, having a safe asset resulting from a common EU public debt financing mechanism would also make our life easier in terms of monetary policymaking. It would also be relevant to foster financial integration. So yes, it's important

to emphasise the role this fund is going to play during the recovery. But it's important to stress that it should also be the origin of a permanent instrument.

In Parliament you recently pointed out the risks involved in the Spanish government's decision to increase pensions and public salaries in 2021. You also warned that the macroeconomic forecasts on which the budget is designed are likely to be revised downwards. How would you describe the executive's economic management of the crisis? Are you satisfied with the way it is designing investment plans linked to the Next Generation EU funds?

Unfortunately, the crisis has had a very deep effect on the Spanish economy; in relative terms, even higher than in most other eurozone economies. This is partly due to our productive structure, which is more biased towards sectors that have been more affected by this crisis. It's also due to some structural issues of our economy, such as a high level of temporary workers. This adds volatility to the labour market. We also have a high share of small and medium enterprises that we know are more fragile when facing the type of crisis we are going through now.

In this environment, the Bank of Spain has said the right and the optimal fiscal policy was to have a very active, expansionary policy. This is a transitory shock, even if we don't know how long it will last. The main objective of the fiscal-monetary policy response in the eurozone is to prevent this temporary shock from permanently damaging the economy. I still think it is the right reaction. The positive news related to the vaccine are crucial but we know it will take some time to translate into positive economic outcomes. Therefore, it's important that fiscal policy remains very supportive.

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This is absolutely compatible with acknowledging that one of the main negative consequences of this crisis will be that the level of public debt of this country will be much higher. It was already 95% of GDP before the crisis; we had a structural deficit of close to 3%. This will only become worse due to the crisis.

My proposition in Parliament has been that we first acknowledge the problem. Second, that we start to prepare for the consolidation process that will be needed to stabilise and reduce debt and the public deficit – even if, as I have argued, it's not the right moment to start the consolidation process. And that this is accompanied by implementing the structural reforms that we know are absolutely needed.

We also should allow the labour market to work in a flexible manner so that companies that are facing a permanent reduction in demand are able to adjust. This is why I am also emphasising the role active labour market policies should play in the current context. And in this aspect, the Next Generation EU fund is crucial. These funds have the capacity to make a difference. But they will have to be deployed through a very selective process, where we do not just think about its impact on the short term. It's even more important that they are focused on increasing the potential output growth of this economy with a mid-term

perspective. It's a difficult combination: these projects should be defined as quickly as possible but they should be designed to have a long-lasting effect.

When you became Basel Committee chair, you said global public good would be an area of focus. What work remains to be done in this area?

As a general principle, the Basel Committee is driven by a mandate to enhance global financial stability for the public good. Over the last decade, we've been focusing almost exclusively on trying to solve the fault lines exposed during the global financial crisis. This led to the Basel III reform, finished in December 2017. This has played a crucial role contributing to safeguarding the stability of the banking sector during the current crisis. Now that we have finished the Basel III reform, it's time for implementation. Also, we are starting an evidence-based evaluation of these reforms. We want to see to what extent they have achieved the objectives we have previously established, and study whether they may have had some unintended effects.

But independent from these reforms, there are still important cross-border financial stability issues on which we will have to focus. For example, that banks remain resilient to the current crisis – a shock that is entirely exogenous to the banking sector. There is also a challenge with banks' business models in the current low interest rate environment and the emergence of new players that are competing for their market shares. The comprehensive technology transformation we are facing in different domains is having a profound impact on banks. This also entails some risks and challenges, as well as opportunities for banks that we need to analyse.

In the past, perhaps we did not prioritise supervision, as we were focused on regulation for very good reasons. But promoting strong supervision, and co-operation in this field, is very important. For example, including operational issues that are becoming very relevant during the current crisis, the use of data analytics in supervision...

Our overarching global public good is financial stability, and we must always scan the horizon to see what elements can become challenging. And there are always new elements. Only focusing on past drivers is not the right thing to do. At the Basel Committee level, we've just completed a strategic review which was endorsed by the Group of Governors and Heads of Supervision (GHOS) in their last meeting. With it, we wanted to gain more flexibility within the Basel Committee to focus on to these new, emerging risks.

Facing the pandemic, jurisdictions across the world have focused on making sure credit kept flowing to businesses and households, which may have undermined Basel III in the short run. What lessons has the Basel Committee drawn from the Covid-19 market stresses?

It's too early to draw lessons. In the context of this evaluation programme that we are launching, we are also focusing on the lessons learned from the current crisis. This is a kind of test for our framework. Without trying to anticipate what the conclusions will be, for me, at least now, the main lesson is that building resilience is of key importance before a crisis emerges. So far in the Covid-19 crisis, the financial sector has been able to help the rest of the economy. The fact that this has been the case is, in my view, precisely because we've

carried out this regulatory reform during the last decade. This has put banks on a more resilient footing, balance sheets are in a better place and capital levels are much higher.

Secondly, it's important to point out that keeping this resilience matters also during the crisis. If you take into account the GDP contraction in major economies will record in 2020, and you compare it with our stress tests, you would see we've never carried out an exercise as severe as the current crisis. From this point of view, it was important that monetary and fiscal policy accompany efforts to boost the resilience of the banking sector. And this has been the case. The public guarantees and TLTROs are good examples of this.

It is also important to stress that capital buffers have been built to be deployed in a situation such as the one we are facing. This is why we put so much emphasis on buffer usability. There is of course a question mark – since the crisis has not yet strongly hit banks' profit and loss accounts, it is too early to say whether this buffer usability will take place or not.

"Building resilience is of key importance before a crisis emerges".

Finally, it's very important that we don't forget that resilience will also matter after the crisis. Basel III implementation will become absolutely crucial after the crisis, because all reforms that have not been implemented yet are also very relevant. They are still deemed very relevant and they will have to be applied in full. We also need to focus on new risks related to technology, to business models, the low interest rate environment, technology dependency, climate change, etc. We cannot stop looking at all these risks in international fora and to take the appropriate decisions to mitigate then.

The Financial Stability Board recently stressed the role played by non-banking financial institutions in the market turmoil experienced in March and April. ECB vice-president, Luis de Guindos, has called for a comprehensive macro-prudential approach to the sector, including higher capital requirements. What is your view of non-bank risks? Have Basel rules created some of the problems and how should they be addressed?

Looking at the current crisis, it's worth recalling that indeed we observed significant increases in volatility and abrupt market corrections in March and April. The reaction of different policymakers quickly stabilised markets. Nonetheless, we also noticed some limitations regarding the behaviour of the non-banking sector, in particular investment funds' capacity to bear risk. This typical procyclical reaction is something we policymakers don't like, because it makes financial markets act as a kind of amplifier of the shocks derived from price movements.

Many policymakers are making this same point, including the FSB – that we have to analyse the development of macro-prudential tools for non-banks. That's crucial. In particular, capital or liquidity requirements could strengthen the capacity of these intermediaries to absorb shocks in periods of stress, and avoid this procyclicality.

In this regard, it is important that there is a co-ordination with the macro-prudential framework of banks. There are two issues about the interrelation between the bank and non-banking sectors that are relevant to me. First, to what extent the current regulatory

perimeter for the banking sector in particular is the correct one or not. The borders separating banks and non-banks are becoming a bit blurry. The second one is interconnectedness between both fields, including the fintechs and also the big techs. To a certain extent, I think the March market turmoil underlined not only the direct, but also the indirect role played by the banking sector across financial markets. As a result, both the regulatory perimeter and these interconnections should be analysed by the Basel Committee.

The latest progress report to the G20 noted several gaps in Basel III implementation, including for rules that should have been put in place by now. What more can be done to enforce the rules? Is evaluation/transparency good enough? Are you concerned by any jurisdictions backsliding? What about overlap areas: are there segments of the new oversight regime that need to be rolled back?

I think it's important to take a step back and acknowledge that we've accomplished substantial achievements, building a common global regulatory framework, a common regulatory level playing field with the Basel framework. Not only in theory, but also in practice. We also have to take into account that the Basel standards are not legally binding. This is soft law that requires legislative procedures to be implemented. Having said that, the Basel Committee put in place the RCAPs (Regulatory Consistency Assessment Programmes) in 2012. This has led to a very rigorous and very transparent review process. It's true there is always an element of non-compliance, and this is precisely why it was created. But my reading of how it has worked in terms of final implementation is very positive. As a result of the crisis we've seen a full commitment among GHOS members with the implementation of the standards, within the new deadline. This leads me to believe implementation will happen.

Is the Basel Committee worried that some nations, including the US, Brazil or Russia, are deviating from capital and accounting rules? For instance, the US has adjusted the supplementary leverage ratio so banks with more than $250 billion in assets no longer have to set aside capital against their cash and Treasury holdings, while others, such as Brazil, are adjusting risk weights.

We have to take into account we're going through an extraordinary crisis. The fact that the Group of Governors and Heads of Supervision (GHOS) – including the main jurisdictions across the globe – recently tasked the Committee with monitoring the implementation of all the different measures that have been put in place to ensure they are consistent with the Basel framework's objectives – and they are unwound on a timely manner – is in itself an important element of trust. The GHOS has been very clear that we have the same aim: a full and consistent implementation of the Basel framework. And this was completely undisputed.

It's true that there were individual, temporary measures during the crisis, going beyond the flexibility of those standards: to respond to extreme financial conditions and to provide operational resilience to financial institutions. That is clear. But at the same time, I'm confident that all of our members are willing to implement the Basel III framework in full, and that they will unwind these temporary measures in a consistent and timely manner.

EU legislators appear set to introduce a ‘parallel stack’ alternative to the output floor developed by the Basel Committee that requires banks to ensure their risk-weighted assets (RWAs) calculated using their own models are not lower than 72.5% of the RWAs that their businesses would generate using the standardised approaches. The EBA warned against “circumventions” a year ago. What are the issues here and are you disappointed with the EU’s position on this, which is expected to significantly reduce the output floor’s effect in Europe?

I won’t comment on speculations about alleged approaches to the implementation of Basel III standards by individual jurisdictions or regions. But let me stress our expectation is a full, timely and consistent implementation of the Basel III framework. And this includes, of course, the output floor. It is in everybody’s interest to have a common global level playing field in the prudential regulation of international active banks. This was the GHOS view in a very recent meeting that we had.

“Our expectation is a full, timely and consistent implementation of the Basel III framework”.

The output floor plays a key role in restoring confidence in banks’ models for risk-weighted assets (RWAs). The objective is to provide a comparable set of RWAs and capital ratios across banks based on standardised approaches. It’s absolutely crucial that these are calculated consistently across banks to reap the full benefits of these regulations. This is the reason why the Committee agreed to a global, consistent output floor. In the hopefully highly unlikely scenario that there are potential deviations in the way the Basel standards are implemented, this will be transparently identified and publicly communicated as part of our RCAP. But I firmly believe this won’t be the case.

Basel III failed to introduce risk weights for sovereign debt held by banks. As sovereign debt risk grows further still due to government fiscal spending linked to their Covid-19 responses, isn’t this potentially a fatal flaw in the new accord?

The Committee is of the view that all sovereign exposures entail risk. There is a rich history of sovereign defaults and banking crises that have preceded, accompanied or followed episodes of sovereign distress. In other words, the bank-sovereign nexus is real. But we also have to recognise that there is a holistic role played by sovereign debt. It is key for banks’ liquidity management, it’s crucial for monetary policy and obviously for fiscal policy. And in many jurisdictions banks are the primary investors in government debt. The question here is how to best balance the prudential risk concerns relative to these holistic, broad considerations. In 2017, the Committee published a discussion paper setting out a range of potential ideas related to the regulatory treatment of sovereign exposures that could benefit from a broader discussion. However, it’s also true that at that stage there was no consensus to make any changes to the system’s regulatory treatment. There was the consensus that the Committee would continue reflecting on this topic, including now with regards to the impact of Covid-19.

How do you assess the effectiveness of the capital buffers and the fact banks do not appear to have run them down during the Covid-19 shock due to concerns it may indicate some form of weakness?

In this debate, it is important to acknowledge the objectives of these buffers and also to look at the evidence. The objectives of these capital and liquidity buffers under the Basel III framework are focused on allowing banks to absorb shocks, without breaching minimum requirements – and to maintain lending to creditworthy households and businesses. This is important because these decisions were taken following the painful experience of the global financial crisis, when we saw banks abruptly cutting back their lending to the real economy in order not to breach minimum requirements. This exacerbated the duration and the depth of the crisis. Now, it is premature to reach conclusions about the effectiveness of these buffers. Partly, this is due to the extraordinary range of measures deployed by central banks and fiscal authorities in response to the pandemic. These have helped banks to absorb the shock.

It's also worth bearing in mind there hasn't been any significant restriction on lending to the real economy. In this sense, the mechanism that was put in place has been successful, and it has not been necessary to use the buffers until now. But, of course, it's important to look ahead as the crisis continues to unfold. It's only a matter of time until losses appear in banks' loss and profit accounts. In fact, we're seeing some initial signs of this potential tightening in bank lending conditions, although it's always difficult to disentangle whether this is due to supply or demand factors.

This is why the Committee has publicly reiterated that a measured drawdown of buffers is appropriate and that supervisors should provide sufficient time for banks to restore these buffers. But in any case, we should wait before making an evaluation of the lessons learned from the crisis and see whether there are more structural issues. Some people are already stressing that there may be a need in the future, with the same level of capital requirements, to have higher cyclical capital buffers in relation to structural buffers. The effectiveness of buffers is something that we will have to analyse at the Basel Committee at some point, but only after we study the evolution of the situation over the coming months.

US president-elect Joe Biden places climate change as one of the key topics of his policy agenda. If the Fed adopts a similar policy position, which it seems to be doing, do you think there will be reforms to the Basel framework to incorporate climate risks?

Climate change is one of the major global financial stability issues at present. It's generally accepted that such risk, including the physical and transition risk, could potentially impact the soundness of individual banks. These factors can also have broader financial instability implications for the banking sector. The pandemic has further underlined the importance of mitigating the risk of high-impact events. We need to face this risk and react in order to mitigate it. The Committee has a dedicated task force that was put in place to assess the transmission channels of this risk and the measurement methodologies used to quantify it. We are also developing effective supervisory practices to mitigate the impacts of climate risk and we will examine whether there are any gaps in the current Basel framework with regard to such risk. There are many forums looking at this issue and we co-ordinate our actions with them, including the Network for Greening the Financial System, which the

Federal Reserve Board joined very recently. This is an important issue that the Committee has to look at in detail with the main objective of guaranteeing global financial stability.

Given the measurement data challenges, and the fact that stress tests have a longer time horizon compared with regular bank stress tests, what timeline is realistic to fully incorporate these features into the Basel framework?

It's obvious that it has to be longer than the normal periods that we have. But at the same time, it's also important to emphasise that the time we have in this regard also very much depends on the action of other policymakers. If one of the main risks related to climate is transition risk, this depends very much on the swiftness of action by fiscal policymakers and to what extent they provide a transition period for this transformation to happen. We know this might lead to non-financial companies that today are profitable becoming less profitable. And the opposite for others. This is one of the risk that will affect banks' balance sheets. It would be important that there is some degree of co-ordination, so that when other authorities take action in this field they take into consideration financial stability issues.