Old risks, new challenges, same objective: the work programme of the Basel Committee in 2022

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Introduction

Good morning, and thank you for inviting me to speak at the Eurofi High-Level Seminar, in association with the French EU Council Presidency. It's a pleasure to be in Paris with you today.

This year will mark the fifteenth anniversary of the Great Financial Crisis (GFC). The GFC may seem a distant memory to some of us considering all that has occurred since then. Terms such as PCR tests and distributed ledger technology were outside the purview of most people back then. "Zoom" was rarely used as a verb to connect with others. And the world was only starting to get acquainted with quantitative easing programmes.

The global banking system has also undergone major changes since the GFC. The initial Basel III reforms have fundamentally bolstered the global regulatory framework.[1] As set out in a recent evaluation report by the Basel Committee, banks are now better capitalised and have stronger funding profiles than in 2007.[2] This enhanced resilience, coupled with the large-scale public support measures, played a key role in safeguarding banks during the Covid-19 pandemic. Unlike the GFC, banks continued to lend to households and businesses. They now have the opportunity to play an important role towards contributing to a sustainable and inclusive economic recovery.

Structural trends are also affecting and shaping the global banking system. The digitalisation of finance, growth in non-bank financial intermediation (NBFI) and climate change may all create risks to global financial stability and raise important supervisory questions. Many of these risks are cross-sectoral in nature, requiring ongoing coordination and collaboration with other international forums and global standard-setting bodies.

Yet, despite all these trends, we are also seeing the re-emergence of more "familiar" risks. Inflationary dynamics and the prospects of tighter monetary policy across several jurisdictions have gyrated financial markets. The risk of "snapback" changes in interest rates could test borrowers' debt service capacity, with private and public debt levels surging to historic highs. Risks of a house price correction have been building in recent years amid a substantial rise in housing valuations in a number of jurisdictions. While the drivers behind these developments may differ from historical events, their potential impact on the banking system – whether in the form of credit, market, interest rate or liquidity risk – is not unfamiliar.

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[1] See Borio et al (2020) for a summary of the Basel III reforms.

[2] See BCBS (2021f).

And there is still unfinished business when it comes to implementing Basel III, including the outstanding standards aimed at reducing excessive variability in banks' risk-weighted assets (RWAs). We cannot afford to forget the lessons from the GFC.

So against this backdrop of both new and more familiar challenges and risks, what lies ahead for the Basel Committee in 2022 and the medium term? Four broad themes underline our strategic priorities, which I will briefly cover.

Covid-19 resilience and recovery

First, the Committee will continue its work related to Covid-19, with a view to ensuring that banks remain resilient and contribute to the recovery. The past few months have reminded us that the transition from pandemic to endemic is likely to be a bumpy one. Green shoots have sometimes failed to take root. The outlook continues to be marred by uncertainty and divergences across regions. Per capita incomes in 2023 will remain below their 2019 levels in nearly 40% of emerging market economies, in contrast to advanced economies.[3]

While the global banking system has largely weathered the pandemic to date, it is crucial that banks and supervisors remain alert to risks and vulnerabilities as the pandemic continues to unfold. This includes managing risks related to frothy asset valuations, embedded leverage and the trajectory of interest rates, with rising energy prices and supply disruptions continuing to drive inflation in several jurisdictions. Debt levels – encompassing both public and private debt – are at an all-time historic high of nearly $300 trillion or 350% of global GDP.[4] The unwinding of public support measures – which were critical in shielding banks from losses thus far – means that banks will have to increasingly rely on their own resources to absorb potential shocks.

In addition to risky asset prices, in many jurisdictions the combination of buoyant housing markets together with highly leveraged households and real estate developers is increasing banks' vulnerabilities. The risks of a sharp house price correction triggered by changes in interest rates or financial costs will test banks' resilience in the event of a debt overhang and economic slowdown.

Indeed, an increasing number of jurisdictions are deploying macroprudential measures – such as activating or increasing the Basel III countercyclical capital buffer – in response to elevated risks. Such measures seek to ensure that banking systems are able to absorb shocks and maintain the provision of key banking services in both good and bad times. Vigilance should continue to be the watchword.

We must also learn from the experience of the past few years to help guide future areas of work. The Committee is evaluating whether the implemented Basel III reforms have functioned as intended during the pandemic. Our preliminary assessment indicates that the banking system would have faced greater stress during this period had these reforms not been adopted and in the absence of public support measures. This is an important message and a further reminder that a prudent regulatory framework underpinned by well-capitalised banks is key to securing financial stability.

[3] World Bank (2022).

[4] IIF (2021).

We have also identified some areas in the Basel Framework – including the usability of capital and liquidity buffers and potential procyclical dynamics in the risk-weighted framework – that we will continue to evaluate this year. And we are also conducting a more comprehensive evaluation of the implemented Basel III standards drawing on the evidence from the past decade. As ever, this work will be guided by rigorous empirical evidence and analyses.

Horizon scanning of emerging risks and structural trends

The second area of focus for the Committee is our continuous and proactive horizon scanning of emerging risks and structural trends affecting the global banking system. This includes the ongoing digitalisation of finance, which is reshaping the range of financial services on offer, the distribution channels of these services and the suppliers behind them.[5] Building on our report from a few years ago on the implications of fintech for supervisors and banks, we are conducting a set of deep-dive thematic analyses to gauge the impact of these drivers on banks and their strategic responses.[6] We will then consider whether any additional global supervisory or policy measures are necessary.

A related area of focus for the Committee relates to cryptoassets, a market that reached almost $3 trillion in market valuation last year, compared to roughly $20 billion just five years ago. While banks' exposures to cryptoassets are relatively low at this stage, the potential for this market to scale up rapidly and the wide range of potential direct and indirect channels of bank exposures raise financial stability concerns. The dynamic nature of cryptoasset markets necessitates a proactive and forward-looking regulatory response. To that end, the Committee is cooperating closely with other global bodies to assess the cross-border financial stability risks from cryptoassets and identify any gaps in the global regulatory framework. One such area relates to the prudential treatment of banks' exposures to cryptoassets, where we plan to consult again in mid–2022, following our initial consultation last year.[7]

The Committee will continue to work on mitigating climate-related financial risks. Financial risks from climate change are global in nature and therefore necessitate a cross-border response. A recent study estimates that G20 financial institutions have nearly $22 trillion of exposures to carbon-intensive sectors, of which on-balance sheet bank loans account for 60% of such exposures.[8] It is therefore crucial to ensure that climate-related financial risks are adequately captured in banks' risk management practices, disclosures, supervision and regulation. Given the scale, scope and time horizon of these risks, the Committee is pursuing a holistic approach to ensure that banks and supervisors adequately measure, disclose and mitigate such risks.[9]

In 2022, we plan to finalise a set of global principles for the effective management and supervision of such risks, following our consultation last year.[10] We will also liaise with the International Sustainability Standards Board and other global forums to ensure that banks' Pillar 3 disclosures adequately reflect their climate risk profile. And we are assessing whether there are any potential gaps in the Basel Framework for mitigating such risks.

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[5] See Hernández de Cos (2019).

[6] See BCBS (2018).

[7] See BCBS (2021e).

[8] See Moody's (2021).

[9] See BCBS (2021c, 2021d).

[10] See BCBS (2021h).

Strengthening supervisory coordination and practices

The third strategic priority for the Committee is aimed at strengthening supervisory coordination and practices. This includes ongoing work aimed at safeguarding banks' operational resilience. Covid-19 has been a real-life stress test of banks' operational resilience, as it is taking place against an evolving landscape dominated by increasing cyber threats, a growing reliance on third- and fourth-party service providers and a move towards greater remote working arrangements.

As noted recently by the Committee, it is crucial that banks continue to improve their resilience to cyber security threats and incidents, including through the widespread adoption of tools, effective practices and frameworks based on widely accepted industry standards.[11] Going forward, the Committee will oversee the effective implementation of its recently finalised principles to enhance the operational resilience of banks and the revised principles for the sound management of operational risk.[12] And we plan to publish further supervisory observations related to banks' concentration risk management frameworks and reliance on third- and fourth-party service providers.

The Committee is also carefully assessing the supervisory implications of the digitalisation of finance, including with regard to the role of artificial intelligence and big data. We plan to publish initial supervisory observations in this area in the coming months.

Another striking trend over the past decade has been the growth in NBFI, which raises important supervisory questions for the Committee given the interconnectedness between banks and non-banks. Since 2015, banks' claims on NBFIs have grown by almost 70% and now comprise almost $7.5 trillion in claims and $6 trillion in liabilities.[13] Events over the past few years, including the March 2020 market turmoil and recent episodes of NBFI distress, have highlighted how these channels of interconnections can pose risks to banks. The Committee will continue to work closely with other global forums to ensure that banks and supervisors adequately manage these channels of risks, drawing on the lessons learnt from recent events.

Basel III implementation

The last, but certainly not least, area of focus for the Committee is to promote the full, timely and consistent implementation of all aspects of the Basel III framework, including the outstanding standards. Doing so will help lock in the benefits of these standards to ensure that banks can withstand future crises.

I have previously discussed the importance of implementing Basel III in a full, timely and consistent manner in Europe, so I will limit my remarks today to the following points.[14]

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[11] See BCBS (2021g).

[12] See BCBS (2021a, 2021b).

[13] See FSB (2021).

[14] See Hernández de Cos (2021a, 2021b and 2022).

First, the gravity of the regulatory fault lines that the outstanding Basel III reforms aim to address remain as important today as they were pre-pandemic. Recall how, at the height of the GFC, market participants lost faith in banks' reported capital ratios and relied on other measures of bank strength.[15] More than a decade later, concerns about the variability in banks' RWAs continue to persist. For example, a recent report by the European Banking Authority on banks' modelled capital requirements points to a "significant" level of capital dispersion "that needs to be monitored."[16] We cannot afford to continue to let these fault lines linger, especially at a time of increasingly elevated financial risks.

Second, it is increasingly clear that the outstanding Basel III reforms will complement the previous ones in having a positive net impact on the economy. 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.[17] It also finds that potential deviations from the globally agreed Basel III reforms – for example, with regard to the output floor – would significantly dilute the benefits to the real economy. It is therefore incorrect to assert that there is a trade-off between bank resilience and economic growth. The former is a fundamental prerequisite to achieving the latter.

Third, implementing Basel III in full and consistently is a powerful symbol of jurisdictions' ongoing commitment to multilateralism. It is in our collective interest to implement Basel III in a timely way, so that we are able to focus our attention and resources towards emerging risks and structural trends affecting the banking system. Fifteen years after the GFC, we owe it to our citizens across our jurisdictions to demonstrate that we have adequately addressed the fault lines in the banking system. In that respect, the Group of Central Bank Governors and Heads of Supervision – the Committee's oversight body – recently reaffirmed its unanimous expectation of implementing all aspects of the Basel III framework in full and consistently, and also underscored the importance of implementing these standards as soon as possible.[18] The Committee will continue to monitor the implementation of Basel III as part of its Regulatory Consistency Assessment Programme.

Conclusion

In conclusion, we find ourselves at a juncture characterised by new challenges and the re-emergence of more familiar risks. The transition from pandemic to endemic is likely to bumpy and uncertain. What is certain, however, is the Basel Committee's commitment to close and effective collaboration, driven by our mandate to strengthen the regulation, supervision and practices of banks worldwide for the purpose of enhancing financial stability.

Thank you.

[15] Barclays Capital (2012).

[16] EBA (2021).

[17] Budnik et al (2021).

[18] See BCBS (2022).

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