Basel Committee
on Banking Supervision

BIS

Banking starts with banks: initial reflections on recent market stress episodes

Pablo Hernández de Cos
Chair of the Basel Committee on Banking Supervision and Governor of the Bank of Spain

Keynote speech at the Institute of International Finance Roundtable on the Shifting Risk Landscape
Washington DC, 12 April 2023

Introduction

Good morning, and thank you for inviting me to speak at this roundtable.

I should start with a confession. I spent some time debating what to cover in my speech today. The Basel Committee recently published its work programme for 2023–24, which covers a wide range of analytical, supervisory and regulatory initiatives.[1] This includes work on medium-term structural trends affecting the global banking system, including most notably the digitalisation of finance and climate-related financial risks. It also covers important supervisory initiatives on updating the core principles for effective banking supervision, assessing banks' interconnections with non-bank financial intermediation (NBFI) and shoring up banks' outsourcing practices and reliance on third- and fourth-party service providers. Any one of them would have been worthy of a speech in its own right.

But, in the end, I decided to focus my remarks on the recent episodes of banking stress and the implications for the Committee's work. In many ways, this was perhaps the first "real" stress test of the banking system (or at least parts of it) since the Great Financial Crisis; as many have previously observed, the banking system benefited from the huge scale of public support measures during the Covid-19 pandemic.[2] And, if the pandemic was a stress test, it stemmed from an exogenous shock, not a financial one. So it is important to take a step back and ask what happened, why it happened, and what it all means for banks, regulators and supervisors.

As you may have seen, the Committee recently announced that it is reviewing recent market developments and will take stock of the regulatory and supervisory implications from recent events, with a view to learning lessons.[3] This work has already started. The Committee will discuss the outcome of this work in due course. So, in the meantime, I will be speaking today in a strictly personal capacity, offering some preliminary observations and raising some questions for

[1] BCBS (2022d).

[2] Hernández de Cos (2022a, 2022b, 2022c).

[3] BCBS (2023).

further reflection. I will not prejudge the outcome of the Committee's stocktake, and I shall also refrain from commenting on individual banks or jurisdictions.

Back to (banking) basics

There has been no shortage of commentary on the recent turmoil in the banking system. Fingers have been pointed at banks' risk management failings and ineffective governance, including with regard to NBFI exposures, interest rate risk and liquidity risk. Some commentators have been quick to highlight regulatory and supervisory frameworks. Others have dug up prescient statements about risks to banks; the Committee itself has been warning about the risks to banks from rising interest rates and a worsening macroeconomic outlook for over a year now.[4] And, alongside the Committee's own stocktake, many authorities are also in the process of reviewing the past few months and the lessons learnt.

Yet, unlike the Golden Age of whodunnits, there is unlikely to be a single culprit that will be revealed at the end.[5] Instead, multiple factors are likely to have contributed to a series of the stress episodes, with numerous implications for banks and supervisors going forward. What's more, history suggests that it may take some time to have a complete picture and assessment of what happened, why it happened, and where do we go from here.[6] So my first observation today is that we should be humble and open-minded at this stage when it comes to assessing recent developments and the implications for banks, regulators and supervisors. We should not hastily jump to conclusions, nor should we close any doors. Nevertheless, once our stocktake is completed, remedial actions should be taken if deemed necessary.

With that caveat in place, my first preliminary takeaway from recent events is that we need to start by asking why, in 2023, some banks have failed to meet basic risk management and governance practices. To be clear, this is not necessarily a general pattern across the banking system and is more of a tail event. But, in times of stress, the financial chain is only as strong as its weakest link. Sound risk management and robust governance practices are the bread and butter of bank management. 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. Jumping straight to discussions about the regulatory and supervisory implications of recent events is akin to forgiving banks for not fulfilling their primary responsibilities and likewise shareholders for not exercising due diligence.

The essential role of these banking building blocks has long been recognised and articulated by the Committee. For example, the Basel framework stipulates that "bank

[4] BCBS (2022a, 2022c).

[5] Symons (1972).

[6] For example, the Pecora Investigation on the Wall Street Crash of 1929 concluded in 1934 (Pecora Commission (1934)); the Financial Crisis Inquiry Commission on the 2007–09 Great Financial Crisis published its report in 2011 (FCIC (2011)); the report on the 2008 failure of HBOS was published in 2015 (FCA and PRA (2015)). And, in my own jurisdiction, the Bank of Spain's report on the financial and banking crisis in Spain from 2008 to 2014 was published in 2017 (Bank of Spain (2017)).

management is responsible for understanding the nature and level of risk being taken by the bank and how this risk relates to adequate capital levels".[7] It goes on to note that bank management "is also responsible for ensuring that the formality and sophistication of the risk management processes are appropriate in light of the risk profile and business plan".[8]

These supervisory expectations are complemented by a set of additional guidelines on corporate governance principles for banks worldwide, which cover banks' risk management function and the role of senior management and the Board.[9] Meeting these guidelines should not be a box-ticking exercise but rather should take the form of a deeply embedded mindset at all levels of any bank.

These banking "basics" also apply when it comes to the fundamentals of risk management and oversight by banks. A bank's Board, senior management and risk management function should be asking themselves questions in a timely fashion and taking credible measures to shore up resilience. They should respond promptly to material developments such as the rapid growth of a bank's balance sheet, an excessive reliance on a limited set of revenue or funding sources, ineffective asset-liability management, a growing number of misconduct incidents, changes in the economic environment such as (expected) changes in interest rates or economic growth, or the inability to consider a broad set of "what if" stress-type scenarios.

Strong(er) supervision

Moving on to supervision, I will limit my remarks at this stage to an observation and a question.

First, my observation: the degree of cross-border supervisory cooperation at the level of the Basel Committee in response to recent events has been effective. Basel Committee members cooperated throughout recent banking stresses to help restore financial stability. The Committee itself held several meetings to facilitate the exchanging of supervisory information and cross-border collaboration during a period of acute stress in the banking system. We should not take this for granted. And building on the Committee's almost 50 years of facilitating and promoting global supervisory cooperation, we should always seek opportunities to continue to improve on this front, as needed.

And now my question: as memories fade and complacency sets in after each banking crisis, how can we best preserve the strength and robustness of supervision over time? To be clear, I am not referring to the willingness of supervisors themselves to oversee banks, identify failings and challenge management effectively. Instead, I am referring to the broader environment and the extent to which it facilitates, or hinders, the ability of supervisors to take decisions that may be unpopular.

---

[7] BCBS (2006).

[8] Ibid.

[9] BCBS (2015b).

Supervisors should ask tough questions and take decisive action to ensure the safety and soundness of banks and to safeguard financial stability. These are public goods that benefit society at large. The privatisation of banking gains and socialisation of extreme losses is not an acceptable outcome. Yet financial lobbies are strong, and the temptations of a "dash for growth" are powerful.[10] At the same time, the rewards from the tough supervisory decisions necessary to avoid banking crises are rarely visible or clear. We never see the counterfactual: supervisory success is an orphan.[11] So it is critical that all of us welcome and support the ability of a supervisor to exercise its judgment and tell a bank that its leverage or maturity transformation is too elevated, or that its business model is unsustainable, or that it needs to adopt prompt and substantive measures to shore up risk management and governance failings.

Avoiding regulatory amnesia

Let me conclude with three remarks on the regulatory implications of recent events.

First, we've again been reminded of the critical importance of having 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 time period and now stand at €12.5 trillion. These reforms have helped contain the fallout of the recent banking stress events.

The benefits of the "multiple metrics" nature of Basel III were also in full evidence. The inclusion of a leverage ratio, large exposure limits and two liquidity standards as complements to the risk-weighted capital ratio in Basel III is intended to create a regulatory framework that is more robust to arbitrage and erosion over time, as each measure offsets the shortcomings and adverse incentives of the others. The Liquidity Coverage Ratio (LCR) standard also includes a series of monitoring tools on banks' funding concentration, contractual maturity mismatch and asset encumbrance; the standard makes clear that, together with the LCR, they "provide the cornerstone of information…in assessing the liquidity risk of a bank".[12] Authorities, market participants and analysts rely on the full suite of Basel III metrics – including the leverage ratio and capital measures based on Common Equity Tier 1 – when assessing the relative capital and liquidity strength of banks.

Second, it is crucial for policymakers to guard against the perils of the regulatory cycle when designing and implementing standards.[13] Memories of banking crises fade over time, whether because of the mere passage of time or due to succeeding events. Vested interests start to gain momentum, and the fallacy of "this time is different" emerges. It tests our will to persevere

[10] Carney (2017).

[11] Ibid.

[12] BCBS (2013).

[13] Hernández de Cos (2019).

with the implementation of post-crisis reforms. We convince ourselves that some reforms may no longer be needed or warranted. Rule-makers are swayed by siren calls to roll back reforms in order to achieve short-term economic objectives.

In fact, many of the potential regulatory shortcomings highlighted by commentators to date have already been considered at the international level. Two timely examples come to mind. The Committee initially proposed the adoption of a uniformly applied Pillar 1 measure for calculating the minimum capital requirements for interest rate risk in the banking book.[14] It had also consulted on the design and calibration of the Liquidity Coverage Ratio, including a series of relatively conservative liquidity outflow factors. [15] In both instances, these proposals were eventually revised, influenced by stakeholder input during the consultation periods on the perceived overly conservative nature of the proposals and the role of banks' own risk management practices.

To be clear, I am not suggesting that the original calibration and design of the Committee's Basel III reforms would have prevented any future bank stress; the aim of these reforms is not to create a zero-failure regime. But it is clear that they would have helped reduce the likelihood and impact of such events. More generally, the Committee's standards are intended to be a minimum global baseline: jurisdictions are free to go beyond them, and encouraged to do so, depending on the characteristics of their banking systems.

So as the Committee proceeds with its stocktake and considers the regulatory implications of recent events, it will be important to filter out the noise from the signal and not to forget the lessons of both recent events and previous banking crises.

My third remark is that the financial stability benefits of Basel III can only be secured if the standards are implemented as intended. This means both the full and consistent implementation of Basel III standards and their application to internationally active banks. The Committee recognises that, depending on local circumstances, it might be appropriate to adopt a proportionate implementation of Basel III for non-internationally active banks. The exact scoping of banks that fall into the "internationally active" or "non-internationally active" groupings is left to member jurisdictions. But the Committee has stressed that "all banks should be subject to supervision commensurate to their risk profile and systemic importance".[16] As recent events have reminded us, there are multiple dimensions to the systemic importance of the failure of a bank, including both first- and second-round propagation effects. The Committee has also underlined that proportionality should not seek "to dilute the robustness" of standards and that "any simpler

[14] BCBS (2015a). The Committee noted that such a measure would "have the benefit of promoting greater consistency, transparency and comparability, thereby promoting market confidence in banks' capital adequacy and a level playing field internationally".

[15] BCBS (2009). For example, the outflow rates for core funding sources such as corporate and retail deposits were set at 75% and 7.5–15%, respectively. The lobbying pushback and assertions of ungrounded calibrations resulted in a dilution of these outflow rates to 40% and 3–10%.

[16] BCBS (2012) and (2022b).

proportionate approaches would [need to be] more conservative to compensate for their lower risk sensitivity".[17]

Conclusion

In conclusion, recent events have further highlighted the importance of a resilient global banking system underpinned by effective bank governance and risk management practices, robust regulatory standards, and strong supervision supported by proactive cross-border cooperation. It is vital for banks and supervisors to remain vigilant to the evolving outlook. The risks of high inflation, lower growth and geopolitical tensions remain as relevant today as they did in early March. Implementing the outstanding Basel III standards in a full and consistent manner remains critical to safeguarding the resilience of our banking system.

[17] Ibid.

References

Bank of Spain (2017): "Report on the financial and banking crisis in Spain, 2008–2014", May.

Basel Committee on Banking Supervision (2006): "International convergence of capital measurement and capital standards", June.

——— (2009): "International framework for liquidity risk measurement, standards and monitoring", December.

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

——— (2013): "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools", January.

——— (2015a): "Interest rate risk in the banking book", June.

——— (2015b): "Corporate governance principles for banks", July.

——— (2017): "The regulatory treatment of sovereign exposures", December.

——— (2022a): "Basel Committee finalises principles on climate-related financial risks, progresses work on specifying cryptoassets' prudential treatment and agrees on way forward for the G-SIB assessment methodology review", May.

——— (2022b): "High-level considerations on proportionality", July.

——— (2022c): "Basel Committee advances work on evaluating Basel III reforms and addressing climate-related financial risks, and approves annual G-SIB assessment", September.

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

——— (2023): "Basel Committee to review recent market developments, advances work on climate-related financial risks, and reviews Basel Core Principles", March.

Carney, M (2017): "Opening remarks to the Bank of England 'Independence – 20 years on' conference", September.

Financial Conduct Authority and Prudential Regulation Authority (2015): "The failure of HBOS plc (HBOS)", November.

Financial Crisis Inquiry Commission (2011): "Final report of the national commission on the causes of the financial and economic crisis in the United States", January,

Hernández de Cos, P (2019): "The future path of the Basel Committee: some guiding principles", October.

——— (2022a): “Implementing Basel III”, February.

——— (2022b): “Old risks, new challenges, same objectives: the work programme of the Basel Committee in 2022”, February.

——— (2022c): “Lessons from Covid-19 on Basel reforms and next steps”, May.

Pecora Commission (1934): “Stock exchange practices: report of the Committee on Banking and Currency”, June.

Symons, J (1972): *Bloody murder: from the detective story to the crime novel; a history*, Faber & Faber, London.