Basel Committee on Banking Supervision
BANK FOR INTERNATIONAL SETTLEMENTS

The future path of the Basel Committee: some guiding principles

Speech by Pablo Hernández de Cos
Chairman of the Basel Committee on Banking Supervision and Governor of the Bank of Spain

Keynote speech at the Institute for International Finance (IIF) Annual Membership Meeting

Washington DC, 17 October 2019

Introduction

Good afternoon, and thank you for inviting me to deliver the keynote speech for this year's membership meeting of the IIF.

It is a privilege to be speaking today as Chairman of the Basel Committee, following my appointment by the Group of Governors and Heads of Supervision earlier this year. Since the establishment of the Basel Committee in 1974, only 10 individuals have previously chaired the Committee. I am honoured to take up this mantle from my esteemed predecessors.

As you know, the work of the Basel Committee over the past decade – under the leadership of Nout Wellink and Stefan Ingves – has been substantive and substantial. The Basel III framework, which encompasses a number of reforms, has fixed many of the fault lines in the pre-crisis regulatory framework.[1] Capital requirements have increased. Greater focus has been placed on truly loss-absorbing resources in the form of Common Equity Tier 1 (CET1) capital. The risk-weighted framework has been overhauled to enhance risk capture and improve comparability in banks' reported capital ratios. A leverage ratio complements this framework by constraining excess leverage in the banking system. Macroprudential buffers – capturing both cross-sectional and time-varying risks – provide an overlay against system-wide risks. And we now have an international framework for mitigating excessive liquidity risk and maturity transformation, through the Liquidity Coverage Ratio and Net Stable Funding Ratio.

The Basel III reforms have unquestionably strengthened the resilience of the global banking system. Since 2011, CET1 capital resources for internationally active banks have increased by 85% to over €3.7 trillion, and high-quality liquid asset holdings have increased by over 60% to €13.6 trillion. The system-wide level of bank leverage has decreased from 28 times to 17 times, with an average Tier 1 leverage ratio of 5.85%.

Through the process of developing its package of post-crisis reforms, the Committee carefully weighed the costs and benefits of regulation. In this regard, there is strong empirical evidence suggesting that the net macroeconomic benefits of capital requirements are positive over a wide range of capital levels, and that the Basel III capital requirements fall within this range.[2] Indeed, if anything, the updated

---

[1] See Basel Committee on Banking Supervision (2017).

[2] See Basel Committee on Banking Supervision (2019).

studies suggest that the range of estimates for the theoretically optimal level of capital requirements is probably either similar or higher than was originally estimated by the Committee in 2010. The benefits of higher capital requirements accrue both to society as a whole, in the form of reduced frequency and impact of banking crises, and to banks directly, in the form of lower funding costs and better-quality lending.[3] This careful balancing of costs and benefits will continue to guide the Committee as it evaluates the impact of the reforms post-implementation.

These reforms are a testament to the strong willingness of Basel Committee members to cooperate on global financial stability issues. At a time of growing strains on multilateralism, the Committee's accomplishments over the past decade highlight the determination of central banks and supervisory authorities to work constructively towards finding global solutions to enhance the resilience of the global banking system.

My speech today focuses on the future path of the Basel Committee. After a few months on the job, and having chaired my first meeting of the Committee in June, I want to outline a set of guiding principles that will help me steer the work of the Committee. These principles are high-level in nature. These will be complemented by a set of longer-term strategic priorities, which the Committee will set out in due course.

Principle 1: Remembering the lessons of the past

The history of banking crises is rich and deep. Since 1920, the average share of countries around the world experiencing a systemic banking crisis in any given year is about 7%.[4] There have been over 150 systemic banking crises around the globe since 1970.[5] The Basel Committee itself was established in the aftermath of a series of banking crises in 1974, the most notable being the failure of Bankhaus Herstatt in then West Germany.

Systemic banking crises have a profound impact on our economies and social welfare. The scars of the Great Financial Crisis (GFC) of 2007–09 are still raw. The IMF estimates that output levels remain below pre-crisis trends in more than 60% of economies.[6] These deviations reflect profound structural changes in economic activity, including lower capital stock investments and diminished total factor productivity. The broader societal impact of the global financial crisis is no less jarring: the crisis has had a significant impact on migration flows and fertility rates.[7] We have yet to feel the full impact of such changes.

And yet, despite the painful experiences of the many occurrences of banking crises, history suggests that the lessons from such events can sometimes be forgotten as part of a so-called "regulatory cycle".[8] Memories of banking crises fade over time, whether because of the mere passage of time ("decay theory") or due to succeeding events ("interference theory").[9] Vested interests start to gain momentum,

---

[3] See eg Gambacorta et al (2016); and Cecchetti and Schoenholtz (2016).

[4] See Reinhart and Rogoff (2009). The cited figure is the simple average of the two-year average share of countries with systemic banking crises.

[5] See Laeven and Valencia (2018).

[6] See International Monetary Fund (2018).

[7] See International Monetary Fund, ibid.

[8] See Carstens (2019).

[9] See eg Thorndike (1914) and Underwood (1957).

and the fallacy of "this time is different" reoccurs. It tests our will to persevere with the implementation of post-crisis reforms. We convince ourselves that some reforms may no longer be needed or warranted, or even that rolling back reforms may be the key to achieving other short-term economic objectives.

This is not a path that I intend to embark on with the Basel Committee. The Committee's work will be guided by a medium-term perspective and will avoid the temptation of falling into a regulatory cycle. I will be relying on three core safeguards to ensure that we do not deviate from this medium-term perspective.

First, the Committee will resolutely pursue its mandate of strengthening the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability. This will define the scope and nature of our work. And the Committee's outputs should be judged against such an outcome.

Second, the Committee will continue its Regulatory Consistency Assessment Programme (RCAP) to promote full, timely and consistent implementation of its reforms. It has delivered tangible benefits to date: a substantial number of deviations from globally agreed standards have been identified and rectified by members thus far. But there is scope to further enhance the timeliness and consistency of implementation, particularly in the light of signs of delays in the implementation of some of the agreed post-crisis reforms. The Committee will further assess the causes of such delays and review whether the existing RCAP toolkit and measures are sufficient to meet the G20 Leaders' recurring commitment to implementing the Basel III framework in full, on time and consistently.

Third, the Committee's policy work will be anchored by rigorous empirical analysis, including a comprehensive evaluation work programme. The Basel III reforms are wide-ranging and unprecedented in their numbers and impact. To that end, the Committee has set up an ambitious work programme to carefully evaluate the impact of its reforms in achieving their intended objectives, and whether the reforms have had any unexpected outcomes, while also remaining mindful of any regulatory gaps in the light of ongoing changes in financial markets. This includes evaluations related to whether individual reforms have achieved their objectives, the interactions and coherence across different reforms, and the broader impact of the Committee's post-crisis reforms. In parallel, the Committee is assessing banks' behavioural responses to post-crisis reforms, including signs of regulatory arbitrage or transactions that do not meet the spirit of the intended reforms. This evaluation work programme will assist the Committee in filtering out the "noise" emanating from the regulatory cycle and to have grounded discussions on whether its reforms are achieving their objectives.

Principle 2: Global engagement and transparency

The Committee has a long and well established history of engaging with external stakeholders. This includes an extensive and transparent consultation process: a permanent forum for deepening engagement with central banks and supervisors around the world through the Basel Consultative Group (BCG), the biennial International Conference for Banking Supervisors, and regular speeches and discussions with interested parties on the Committee's work. Our role as the global standard setter for banks demands nothing short of this.

I intend to build on this commitment to engage transparently with a wide range of stakeholders as part of the Committee's future work and its evaluation of post-crisis reforms. We will continue to seek the views of all stakeholders on the relevant aspects of our work, including academics, analysts, central banks and supervisory authorities, international organisations and public bodies, market participants and the general public. Banking crises affect all of society, so it is important that society as a whole can provide input into the work of the Committee.

Global financial stability also requires effective collaboration and cooperation among different authorities. This includes close coordination between micro- and macroprudential policy authorities, where the Committee provides a natural forum to consider both perspectives when assessing vulnerabilities and designing policy and supervisory measures. In addition, cross-sectoral financial stability issues, such as the recent developments related to so-called "stablecoins" require effective coordination across a number of authorities, including those with responsibilities for consumer protection, anti-money laundering and data privacy, to name just a few. I will ensure that the Committee effectively coordinates its work with the relevant authorities on cross-cutting issues.

I also intend to keep an open mind regarding the Committee's global footprint. The Basel III reforms are often cited as the major post-crisis accomplishment by the Committee. But I believe that an equally important post-crisis development was the expansion of the Committee's membership, resulting in the current 45 members from 28 jurisdictions and nine observers. For example, the BCG has gradually expanded as well over time.

Principle 3: A disciplined focus on global financial stability issues

My third guiding principle is to focus on financial stability issues that require global responses, and to consider the full spectrum of possible policy and/or supervisory responses to such issues.

Financial stability is a global public good. The cross-border spillovers of financial distress can result in an under-investment in financial stability by individual jurisdictions.[10] So an open global financial system requires global prudential standards. Just like how monetary policy may face a "macroeconomic trilemma", one can think of a "financial trilemma", whereby any two of global financial stability, financial integration and national financial policies can be achieved, but not all three.[11] If we want to achieve the first two of these objectives, then this calls for a minimum set of global standards. Failure on this count could result in regulatory fragmentation, regulatory arbitrage and an uneven playing field for internationally active banks.

Accordingly, the Committee will continue to focus its work on those areas that require a global and coordinated response. This is how the Committee adds value and complements the work of its individual members.

Indeed, the need for global standards is not incompatible with additional financial stability measures at the national or regional level. The Committee sets minimum standards to provide a common financial stability baseline across jurisdictions. Jurisdictions are, of course, free and in fact encouraged to go beyond this baseline if the size and structure of their banking system and the associated risks warrant additional measures. Such measures only reinforce global financial stability.

More generally, the Basel Framework provides authorities with the possibility of designing a proportional domestic prudential regulatory regime. As you know, the Basel Framework is expected to be implemented in full by Basel Committee member jurisdictions for internationally active banks. The Committee recognises that non-Committee jurisdictions may wish to implement some or all of the Basel III framework for a number of reasons. And Committee jurisdictions may also wish to adapt a proportionate regime for non-internationally active banks.

---

[10] See Eichengreen (2006).

[11] See Obstfeld and Taylor (1998); and Schoenmaker (2011).