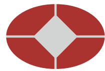

Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Remarks by Mr Stefan Ingves, Chairman of the Basel Committee on Banking Supervision and Governor of the Sveriges Riksbank

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As prepared for delivery

Introduction

I would like to make a few remarks this evening about the current and upcoming work of the Basel Committee. As you may be aware, I will have chaired the Committee for four years this summer (with two more years to go). During this time, the Committee's focus has of course been on post-crisis policy reforms, most notably Basel III. The focus has already begun to change; shifting more towards implementation of the developed standards. But this does not mean that our policy work is done.

The Committee's planned work during 2015 and 2016 can be grouped into four broad themes: (i) policy development; (ii) ensuring an adequate balance between simplicity, comparability and risk sensitivity across the regulatory framework; (iii) monitoring and assessing implementation of the Basel framework; and (iv) improving the effectiveness of supervision.

Today my main focus will be on the first two of these themes: the Committee's policy development agenda and its work on balancing simplicity, comparability and risk sensitivity.

The policy development agenda

The main components of Basel III are essentially done. On the liquidity side, we have finalised the Liquidity Coverage Ratio, the LCR, and the Net Stable Funding Ratio, or NSFR. For these parts of the Basel framework the focus is now on implementation. On the capital side, we have finalised most aspects related to the risk-weighted capital ratio, and we will soon be finalising the calibration of the leverage ratio.

So why do I say that ''most" aspects of the risk-weighted framework have been finalised? On the one hand, the Committee's completed reforms related to the risk-weighted framework have addressed some of the major fault lines of the pre-crisis regulatory framework, including the level and quality of bank capital. But the risk-weighted framework itself has remained broadly intact relative to the pre-crisis framework.

In particular, I would like to highlight the following two aspects: (i) the fundamental architecture of the risk-weighted framework – namely, a high degree of reliance on internally-modelled approaches to determine capital requirements – has essentially stayed the same following the crisis; and (ii) the methods used to measure risk-weighted assets are also essentially the same as the pre-crisis Basel II framework.

And it is on those two areas where the Basel Committee is focusing its policy work. First, we are conducting a "strategic" review of the capital framework, and the extent to which it adequately balances simplicity, comparability and risk sensitivity. And second, the Committee is revising the risk-weighted

approaches across the framework (for credit risk, market risk, and operational risk). Our work here covers revisions to the standardised approaches as well as the internal model-based approaches.

Complexity and risk

Let me say a few words about the work to balance simplicity, comparability and risk sensitivity. I'll start by sharing with you a few quotations, which I think get to the heart of the challenges.

The first are from Mr Andrew Mackenzie, a scientist and the CEO of BHP Billiton (which measured by 2013 revenues was the world's largest mining company). These are from a March interview with the *Financial Times* .[1] On the issue of simple versus complex solutions, Mr Mackenzie notes:

> *"Generally, if things are simple they can often be more appealing — more beautiful, actually. More artistic, if you like."*

He adds:

> *If you want to solve a problem, you make it simpler; it becomes soluble. "Simplicity," he says at one point, "equals truth."*

And finally:

> *There are so many forces in favour of complexity... If you have introduced complexity that employs 10 more people to nurture that complexity, then they will defend it to the death."*

I am somewhat heartened that other industries face the same challenges as we do in trying to reduce complexity. We should continue to be mindful of the inherent bias towards making things too complex. That is not to say that things should be simplistic, but making things complex is not always the best way to capture risk. This brings me to another quote.

This one is from Andrew Tyrie, (former) Chairman of the UK Parliament's Treasury Committee, who asked the following question[2]:

> *"Have you ever turned to a risk modeller as a risk matures and said to him "well spotted, well done – if we didn't have that model we wouldn't have identified that"?"*

I will leave it to you to ponder that question. The best way to summarise this issue is to note that, while models play an important role in risk management, the Committee is carefully evaluating their role in the regulatory framework.

Let me return to the Committee's work agenda and in particular our work on the measurement of risk-weighted assets.

Risk-weighted assets

The Basel Committee's consultation on the review of the standardised approach for credit risk, which began last December, has recently been finalised, and the Committee is now reflecting on the large

[1] Wilson, J. (2015) "Monday interview: Andrew Mackenzie, BHP Billiton CEO", Financial Times, 22 March.

[2] Treasury Committee (2015), 'Appointment of Alex Brazier to the Financial Policy Committee', 17 March.

number of comment letters (more than 160) that we received. The revisions proposed by the Committee are intended to increase risk sensitivity but without adding undue complexity, as well as enhancing comparability of capital requirements across banks and across jurisdictions. The revisions are also intended to strengthen the link between the standardised approach and the internal ratings-based (IRB) approach.

The Committee has been working on a major overhaul of the market risk framework since 2009. In that time we have undertaken three public consultations, and are now undertaking a second comprehensive quantitative impact study exercise. It remains our goal to finalise the standard by around the end of this year.

The financial crisis exposed material weaknesses in the overall design of the framework for capitalising trading book activities. In particular, the level of capital proved to be insufficient to absorb losses. The Committee is addressing these issues in a number of areas, including:

– A revised boundary between the trading book and banking book. The new approach aims to create a stronger and more objective boundary that remains aligned with banks' risk management practices, and reduces incentives for regulatory arbitrage.

– A shift in the measure of risk from value-at-risk to expected shortfall so as to better capture "tail risk", and calibration based on a period of significant financial stress.

– The incorporation of the risk of market illiquidity, through the introduction of "liquidity horizons" in the market risk metric.

– A revised standardised approach that is sufficiently risk-sensitive to act as a credible fall back to internal models, while still appropriate for banks that do not require sophisticated measurement of market risk; and

– A revised internal models-based approach, encompassing a more rigorous model approval process, and more consistent identification and capitalisation of material risk factors.

The Committee has also proposed revisions to the standardised approach for measuring operational risk capital requirements. The revised standardised approach is proposed to replace three current non-model-based approaches, comprising the Basic Indicator Approach, the Standardised Approach and the Alternative Standardised Approach. The consultation period closed in January this year and we are now in the process of reviewing the comments received. In assessing the proposals and the comments received, we should remain mindful of the fact that trying to measure operational risk using a simple accounting-based ratio is only ever going to be a crude approximation at best. But that does not mean that complex modelling is the solution either. In this regard the Committee is also reviewing the costs and benefits of the Advanced Measurement Approaches (AMA) for operational risk, and I expect this is an area where we can agree to significant simplifications while still retaining appropriate risk sensitivity. In the end, operational risk measurement and management has less to do with fitting a distribution to a data set, and is more about managing people and processes, and more generally engraining the appropriate culture and risk governance within a bank.

The revised standardised approaches for credit, market and operational risk will also form the basis for a new capital floor. Floors are not a new phenomenon in the capital framework – the current Basel framework was introduced with a floor based on the Basel I framework. Clearly, having a floor based on Basel I is not a tenable long-term solution. More importantly, a standardised approach floor also serves to:

– Promote market confidence in the measurement of risk-weighted assets by reducing their variation across banks; and

– Increase horizontal equity in risk-weighted capital requirements. Capital floors make for a more level playing field between banks using a standardised approach and banks using internal models for regulatory capital purposes.

Sovereign risk

A discussion of the risk-weighted capital framework would not be complete without a discussion of the Committee's work on sovereign risk – a topic which is clearly of relevance to Europe. At its meeting earlier this year, the Governors and Heads of Supervision – the Basel Committee's oversight body – agreed to initiate a review of the existing regulatory treatment of sovereign risk, including potential policy options.

In many cases sovereign exposures are in fact relatively low credit risk assets and also highly liquid. Yes, they do receive a lower capital charge than other asset classes, but this is generally warranted. But – and this is an important but – I think we can all agree that there is no such thing as a risk-free asset. When we talk about this issue we talk about "sovereign-risk" – not about "sovereign risk-free"

For this reason the Committee will consider potential policy options related to the existing treatment of sovereign risk. It is important to note that this review will be conducted in a careful, holistic and gradual manner.

Coherence of the framework and final calibration

With many of the elements of the reform agenda now agreed – the next logical step from a policy perspective is to assess the interaction, coherence and overall calibration of these reform policies. The aim of this work is to ensure that the various elements of the framework are consistent with their intended objectives, and do not override each other or create unexpected side effects when combined.

For example, how does the leverage ratio interact with the LCR? What is the role of a capital floor relative to the leverage ratio? These are some questions which the Committee will consider.

I do not wish to pre-empt the outcome of this work, but let me offer some preliminary thoughts on the issue.

One of the interactions that is cited as a potential inconsistency is the one between the leverage ratio and the LCR. The LCR requires banks to hold a minimum amount of high quality liquid assets (HQLA) to meet net cash outflows during a 30 day stress period. HQLA comprises a range of assets with various liquidity and credit characteristics – ranging from sovereign bonds, to covered bonds, certain securitisations and listed equities.

The argument is sometimes made that the LCR and leverage ratio, when combined together, penalise banks by forcing them to hold a certain amount of sovereign assets, while at the same time requiring banks to fund a portion of those assets with equity. Is that an inconsistency? I am not so sure. If one did see this as an inconsistency – what would be the alternative policy options? One option would be to not require banks to hold sovereign bonds as part of the HQLA requirement – in which case I am not sure what type of liquidity standard we would be left with. The other alternative would be to exempt sovereign bonds from the leverage ratio. But such an approach goes against the very nature of the leverage ratio which is by design not risk sensitive, and would only serve to reinforce the notion that

sovereign assets are risk free. The apparent inconsistency is really just a consequence of having a leverage ratio that is –by design – not sensitive to risk.

On the question of why both a capital floor and leverage ratio are needed, I would make the following observation. Capital floors provide a risk-sensitive fallback to internally-modelled approaches. Standardised approaches constrain a bank's ability to optimise or game capital requirements, but they are also subject to model risk. The leverage ratio on the other hand acts as a back-stop against model risk and general uncertainty.

There are trade-offs across the various policy objectives that need to be considered. A critical element in ensuring everything fits together as intended is of course the final calibration.

Calibrating the different parts of the framework to fit together is a complex task. It is a complex task from a conceptual point of view, but also in terms of being able to reach an international agreement. Notwithstanding the complexity of this task, the overall calibration is essential in order to have a coherent framework that works as intended. In an ideal world such an exercise would be undertaken in a simultaneous fashion (a general equilibrium type approach). In reality, however, we need to take a step-by-step approach. This involves finalising some elements of the framework, but leaving open some important levers which will allow us to make overall adjustments to the framework in order to get the balance right. For example, the calibration of a capital floor is something that will naturally come towards the end of the process, once we know the impact of the various changes to the risk-weighted assets framework

The work on coherence and interactions will be an important input to the finalisation of the outstanding policy reforms related to the risk-weighted framework and the calibration of the leverage ratio.

Conclusion

I hope I have been able to give you a sense of the current priorities of the Basel Committee. While a large amount of policy and implementation work has been completed, we do have some unfinished business – most of which is focused on the measurement of risk-weighted assets. It is important that the Committee moves quickly to finalise the outstanding policy pieces, while at the same time reflecting on the coherence of the overall framework that has now taken shape.

Thank you, and enjoy tonight's dinner.