



# The need for effective international collaboration in times of financial stress

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Collaboration between financial authorities has never been so testing – and yet never has such cooperation been so important. I will start today by discussing some of the key challenges we face in the area of financial regulation. Then I will argue that the institutional settings for collaboration are actually improving. Given sufficient commitment from the authorities, these new settings and processes will pave the way for enhanced cooperation.

## **1. The challenge of coordination**

Collaboration is a difficult hand to play when the forces stacked against it include profound structural change, roiling financial markets and anaemic growth prospects worldwide. Yet it is precisely these challenges that make it so vital that the regulatory response should be well coordinated internationally. Especially so, when the stresses of deleveraging and balance sheet repair increase the temptation to go it alone and look for policy fixes on a country-by-country basis.

In fact, collaboration should always be part of the solution. In today’s complex times, it is even more important to ensure that the new regulatory framework is effectively and globally implemented. The obstacles that lie ahead should, indeed, be the spur to decisive action. Home supervisors should do their best to keep deleveraging as orderly as possible. The need for coordination becomes acute when measures are taken that may significantly affect other jurisdictions. In particular, the home and host authorities should work together to make sure that supervisory action plans are shared where the implications cut across borders.

So collaboration is critical if we are to successfully implement the new round of financial regulation and improve our institutional settings. And collaboration is also essential in terms of timing. Some would object that banks are being asked to do too much, too soon, and that national supervisors should slow the speed of adjustment. Against that argument, it’s evident that the best positioned banks today are those that have most vigorously rebuilt their capital and repaired their balance sheets. If that is true, then it’s rather the case that too little has been done, and too late, to strengthen financial institutions at the global level since the start of this crisis.

Let me now focus on three specific regulatory challenges where I think international collaboration is particularly indispensable.

## **2. Consistency of regulation, in particular on risk-weighted assets**

A first challenge is the need for a consistent approach to financial risk. This is particularly the case for the calculation of risk-weighted assets. The Basel Committee is set to analyse this issue with a view to ensuring consistency across both banks and jurisdictions. This is critical



to enhancing financial stability, maintaining confidence in the regulatory framework and keeping the playing field level.

As you know, for similar exposures risk-weighted assets calculations vary significantly across borders. Such differences have led some to argue that the risk-based capital regime is fundamentally broken or that it is biased against certain jurisdictions. This is an exaggeration: many of these concerns are based on aggregated data that mask the actual differences in the underlying portfolios of banks. Moreover, the Basel Framework lets banks use their own internal data and models as inputs for the calculation of capital requirements, so that some variation in risk-weighted assets is inevitable.

That said, these calculations do vary enough to warrant further investigation. The bottom line is that minimum capital requirements must accurately reflect the risk that banks actually face. Regulators are therefore doing studies based on benchmark or hypothetical portfolios. The Basel committee will publish the results of this very promising work in the near future. Transparency should be an important component of any eventual solution.

### **3. Treatment of sovereign exposures**

A second and related challenge is sovereign risk – and how it is treated in the Basel Framework interact with persistent financial system fragilities. With confidence in sovereigns waning, the morphing of sovereign debt from a risk-free into a “credit risk” instrument threatens us with consequences that could be both severe and long-lasting.

Two conclusions follow from this prospect. First, timely and forceful policies should be implemented to restore confidence. Sovereigns with strong fundamentals need to earn back their risk-free status by credible and tangible fiscal consolidation. I am happy to note that significant progress has been made in Europe in recent weeks. But structural reforms are also required, if faster trend growth is to be achieved. And, in the meantime, credible multilateral financing backstops are needed to focus the minds of market participants on the fundamental improvements.

So the optimal solution is to address the root of the problem and to restore the risk-free status of the sovereigns. Where this is not the case, and this is the second conclusion, sovereign risk should be appropriately reflected in the calculation of risk-weighted assets. The general principle is that risk exposures should be subject to a regulatory capital charge differentiated according to credit quality. And, contrary to what is sometimes heard, the Basel Framework clearly allows to require banks to hold capital in a risk-sensitive way even for sovereigns, subject to national discretion.

### **4. Liquidity**

A third challenge relates to liquidity. As you know Basel III has introduced two new funding ratios: the Liquidity Coverage Ratio (LCR) to be introduced in 2015 and the Net Stable Funding Ratio (NSFR) for 2018. The LCR’s purpose is to ensure that banks have a sound funding structure that is consistent with the liquidity of the assets they hold. Financial regulators are working to help banks introduce this new global liquidity standard in a timely and appropriate way.

The LCR is currently subject to an observation period that runs until mid-2013. The aim is to fix any unintended consequences of this standard, in particular by looking at the following aspects: the pool of high-quality liquid assets that should be available for use in times of stress; the calibration of net cash outflows; and how central bank policies will interact with banks during periods of stress. The Basel Committee is currently studying all these specific issues. Following the observation period, a number of modifications will be made. But we are unlikely to fundamentally alter the framework’s approach.



Meanwhile, we should keep a tight focus on our key objectives. We must ensure that banks have a stable funding structure and maintain the minimum required stock of high-quality liquid assets in normal times – assets that can be drawn down to meet new liquidity needs in times of stress. To this end, the Basel Committee is working to clarify exactly how the liquidity pool is meant to be used when needed, to provide guidance on the circumstances that would justify a bank’s temporary breach of the liquidity requirement, and to ensure that markets do not unduly stigmatise a bank for using the liquidity buffer appropriately. Needless to say, all these elements will require strong and effective coordination between the national supervisors who will implement the liquidity standards.

## **5. Conclusion**

As was inevitable, we have returned to the subject of international collaboration. Speaking under the lead of Stefan Ingves, the Chairman of the Basel Committee on Banking Supervision who will contribute later during this seminar, I would like to end on a somewhat optimistic note. Some like to point out that Basel II was never implemented worldwide, and why should it be any different for Basel III. So what are the grounds for optimism?

First, a good number of regions have complemented Basel III’s new macroprudential features by setting up key institutions to ensure that the internationally agreed regulations are effectively implemented. The EU has inaugurated the European Systemic Risk Board as the independent body responsible for the macroprudential oversight of the region’s financial system. In the United States, the Financial Stability Oversight Council is tasked with monitoring the US financial system to ensure its stability. And several other countries have recently moved to set up similar institutions, especially in a number of emerging market economies.

Moreover, there are three new elements at the international level that will support adequate collaboration:

- (i) First, international agreements to set up minimum standards are supported by a higher level of political commitment, through the G20 process.
- (ii) Second, the commitment for coordination on the regulatory agenda is endorsed by all the financial authorities represented at the FSB level and is supported by peer review processes.
- (iii) Most important is the peer review process organised at the Basel Committee level to analyse how the Basel Framework will be implemented. Again, transparency will be a very important element as the results of this analysis will be published. The aim is to work on three levels to ensure that: Basel III is adopted in a timely fashion (level 1); that domestic regulations are framed in accord with Basel III (level 2); and that the outcome of capital calculations is globally consistent (level 3).