Post-Basel III agenda for the global regulatory community

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Thank you for the kind introduction. Good afternoon, everyone.

I started my life as a bank supervisor by implementing a cross-border resolution. About a quarter century ago, before dawn on the first Saturday morning after I started to supervise foreign banks in Japan, I was woken up by a phone call from our embassy in London, informing me that the Bank of Credit and Commerce International, BCCI, was put under provisional liquidation. The experience caused me to develop a habit of thinking about prudential policy issues counting backward from resolution.

Having said this, adding something about bank resolution or about deposit insurance to a full day's discussion among IADI members is a tall order for me. Let me therefore choose an adjacent ground: the global regulatory reforms.

It was in November 2008 in Washington, D.C. that the G20 Leaders initiated a comprehensive program of regulatory reforms. More than eight years have passed since then, and many key elements envisioned in 2008 have been finalized or are in the process of finalization. I would like to take this moment to review where we come from and where we are, and explore where we should go from here, what could be our post-Basel III agenda.

Where have we come from?

In Washington D.C., right after the collapse of Lehman Brothers, leaders identified three key culprits for the financial and economic disaster. Who were they?

First, bankers. Let me quote form the Washington Summit declaration: "Market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system."

Second, regulators and supervisors. Leaders said, "Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions."

Third, macroeconomic policy-makers. The declaration maintained, "Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes."

Half a year later in London in April 2009, however, leaders acknowledged macroeconomic policy-makers' post-crisis contribution. The London communique stated: "We are undertaking an unprecedented and concerted fiscal expansion, which will save or create millions of jobs which would otherwise have been destroyed." "Our central banks have also taken exceptional action."

Who then remained to be blamed? In Pittsburgh in September 2009, leaders reversed the order and blamed regulators and supervisors first and bankers next. The Pittsburgh Summit Statement said, "Major failures of regulation and supervision, plus reckless and irresponsible risk taking by banks and other financial institutions, created dangerous financial fragilities that contributed significantly to the current crisis."

It is therefore no wonder that the task of preventing the next crisis was largely put on the shoulders of regulators. An extensive regulatory framework has been designed since then.

Business scope rules keep bankers out of certain risky activities. Risks may materialize from other activities, but with Basel III, banks have a much bigger capital buffer to withstand losses. Banks may still fail, but we now have an elaborate framework to make orderly resolution possible.

In case some resolution may be disorderly, we are implementing OTC derivatives market reforms to avoid undue contagion. A heavy regulatory framework may make intermediation migrate from the banking system to non-bank sectors, but we expand our regulatory perimeter to cover so-called shadow banks. In short, multiple layers of defense have been built.

Economists helped regulators single-mindedly pursue financial stability without worrying much about impacts on sustainable growth. Many of the models employed to estimate the impacts of Basel III assumed that banks adjust only lending spreads, not lending standards, in response to higher capital requirements. They also assumed that central banks will ease monetary policy to cancel out the increase in lending spreads. Some employed the Modigliani-Miller theorem to further dampen the estimated impacts of regulations. There is no wonder, therefore, that most macro-economic models estimated regulatory costs to be *de minimis*.

We thus felt justified to fully step on the brake pedal of regulation to attain stability, while fully stepping on the gas pedal of monetary policy to attain growth.

Where are we?

Where are we after eight years of applying the policy mix of easy money and tight regulation? Are we safer now?

I believe we are. I suppose I do not need to repeat the evidence shown in many reports produced by various international fora to demonstrate this. But regulators should be attentive to the seeds of future defeat hidden in every victory. Let me play devil’s advocate for the time being, for the sake of discussion.

The biggest driver behind the last crisis was the US leveraging: During the six years from 2001 to 2007, the ratio of credit to the non-financial sector to GDP rose by 39 points (from 190% to 228%) in the US. During the seven and a half years from 2008 to mid-2016, the same ratio for all BIS reporting countries rose by 44 points (from 202% to 246%).[1] We are witnessing as rapid global leveraging as we saw in the United States during the period of irrational exuberance.

In spite of the aggressive borrowing by the non-financial sectors, the global economy is more stagnant than before. Each and every year, the IMF's forecasts on world economic growth are betrayed by the reality, always in the downward direction. It looks as if some unknown monster, which the IMF's model cannot capture, hides in the global economy and has been restraining the growth.

Banks are with much larger capital and liquidity buffer, but the profitability, which is the first and the most important line of defense against any shock, is under pressure due to secular stagnation and low-for-long, or the globalized persistence of low interest rates.

We have made great strides in our journey to end too-big-to-fail. Typically, however, a G-SIB fails in an environment where other banks, financial markets and the real economy are weak and vulnerable as well. To the extent we are still in the middle of a journey to prepare ourselves for bailing-in a G-SIB in such an environment, abandoning the bail-out option can make us vulnerable. Timothy Geithner's recent article warns against weakened emergency authorities.[2]

During the last crisis, fiscal and monetary policy tools were mobilized to mitigate the shock on the macro-economy and to sever the feedback loop between the real economy and the banking system. On the other hand, today, the macro-economic policy arsenal is much depleted.

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1 BIS, "Long series on total credit to the non-financial sectors"
2 Timothy F. Geithner, "Are We Safe Yet? How to Manage Financial Crises," *Foreign Affairs*, January/February 2017

Also at the time of the last crisis, we generally avoided a major wave of ring-fencing and serious fragmentation of the global financial markets. During the next crisis, given the growing anti-globalization sentiment, host authorities may be under much stronger pressure to prioritize their domestic depositors and would have less capacity to rely on home authorities. The possibility of uncoordinated national actions causing disorderly resolution may be higher.

In short, if we are to list more worrying sides of the story, we are now with bigger leverage, a weaker economy, declining bank profit, less flexibility in employing certain resolution tools, a depleted monetary and fiscal policy arsenal, and stronger anti-globalization sentiments.

Where should we go?

I do not mean to be alarmist here. What I want to say is that this might be a good occasion to take the time to sit back and think about the overall configuration of our post-crisis policy package.

We developed a major reform program after the crisis, and for the last decade worked extremely hard to put it into reality. There is still important work to be done, particularly with regard to insurance and asset management, but if Basel III is completed, the key elements of the reform program will be there.

I am not suggesting revisiting or rolling back what we have achieved: What we need most now is regulatory certainty and predictability, not the endless rewriting of international standards. But just like a painter who has largely completed a painting and walks a few steps back to look at it from an adequate distance, we may also want to have a retreat at some quiet place near a Canadian lake or a Swiss mountain to think about where we should go, putting aside thick files of Basel meeting documents printed in tiny fonts.

If there should be such an occasion, there are two things I would like to discuss with my colleagues in addition to the points I have already mentioned.

Division of labor between regulation and supervision

First, the division of labor between regulation and supervision.[3] Traditional business models of banking are becoming strained, and declining profitability is posing an ever greater threat to financial stability.

Existing prudential regulations, however, largely focus on the balance between capital held by banks and risks taken by them. A capital buffer is effective in meeting sudden unexpected losses, but cannot withstand a prolonged period of structural low or negative profitability.

To address this, we need supervision, rather than regulation. For example, supervisors can play a role in dispelling bankers' complacency by showing an inconvenient truth. Several initiatives have already been started. US and UK regulators incorporated scenarios of prolonged low or negative rates in the regulatory stress test exercise. The Financial Services Agency of Japan, JFSA, simulated the profitability of regional banks in FY2024 and published the results.

A task more difficult than giving warning is finding business models viable under the low-for-long environment. The responsibility to do so is placed fully on bankers, but supervisors may play a catalyst role taking advantage of the horizontal comparisons they can make across entities under their supervision. The European Single Supervisory Mechanism has made business model analysis a supervisory priority.

Banks have started efforts to reduce costs, increase charges to their customers, and/or consolidate the industry. What seems to be less actively pursued is the strategy of finding ways to create new additional value with their customers. Some banks, however, are having success in growing with their customers by helping corporate customers to enhance their productivity or by helping households to manage their assets better.

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[3] For more on this issue, see speeches by JFSA commissioner Nobuchika Mori "From static regulation to dynamic supervision" (April 2016) and "Between the past and the future" (October 2016), both available on the JFSA website.

This strategy may be more conducive to the sustainable growth of the economy. It would also help attain much needed reconciliation between the financial business and society.

The JFSA has been exploring ways to deepen dialogue with banks on how they can create value shared with their customers. It has, for example, conducted interviews with 751 borrower companies and received written responses from 2,460 firms to identify the needs of the customers not satisfied with their banks yet.

Smarter globalization?

Second, I would also like to discuss the division of labor between global standard setters and national regulators. There are many good and bad reasons for setting standards globally and also for tailoring regulations nationally.

Good reasons for global standard setting include promoting good practices and preventing a race to the bottom, preventing negative spill-overs, pooling scarce expert resources, reaping the benefits of common metrics and languages, reducing arbitrage opportunities, avoiding impositions of conflicting requirements, reducing compliance costs, and leveling playing fields.

The most typical bad reason for resorting to global standard setting is to shortcut the painful process to persuade domestic stakeholders.

The most important reason for tailoring regulations nationally is to reflect differences in developmental stages, market structures and policy priorities.

The most typical bad reason for national discretion is to conceal the vulnerabilities unique to the country. This kind of special treatment may work as a short-term pain killer but often results in bigger calamities afterwards.

A review of these elements may help us find approaches for a smarter globalization of regulations, which would provide more granular guidance where conflicting requirements can hinder cross-border activities,[4] while securing more roles for national regulators in areas with limited spill-overs. That may also help allocate accountability burden better between standard setting bodies and national regulators.

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[4] See speech by former JFSA vice minister Masamichi Kono, "How can regulators do better the next time?" (March 2016), available on the JFSA website.

Let me conclude. When the BCCI collapsed, the Basel Committee had only best practice guidelines for cross-border supervision, the 1975 Concordat. In the wake of the collapse, the Committee reformulated it into a document titled Minimum standards. In spite of its formidable name, it was a six-page document consisting of four very simple principles. While the BCCI resulted in international standards of six pages, Lehman Brothers ended in thousands of pages. The point I want to make today is this: Let us not get lost in the pages but put them in perspective.

Thank you.