Reforms in Banking Regulation – Effects and Outcomes

Ravi Menon
Managing Director, Monetary Authority of Singapore

Keynote Address at Symposium on Asian Banking and Finance
Federal Reserve Bank of San Francisco, San Francisco
11 July 2016

Mr John Williams, President of the Federal Reserve Bank of San Francisco
Distinguished guests, ladies and gentlemen, good morning.

Let me, on behalf of the Monetary Authority of Singapore, express our appreciation to John and his colleagues at the San Francisco Fed.

- It has been a fruitful collaboration on this Symposium.
- We had a good meeting in Singapore last year, and my colleagues and I are very pleased to be here in San Francisco for this year's Symposium.

There has been no lack of excitement for global financial markets over the past year:

- the US Federal Reserve Bank's deliberations whether to raise interest rates;
- China's transition to a more market-based exchange rate amidst a slowdown in economic growth; and more recently
- the decision by UK voters to leave the European Union.

But even as banking stocks have taken a pounding – forgive the pun - the global banking system has generally held up well. There are no doubt fragilities in some European banks, but as yet no disorderly failure or contagion. I think this has at least something to do with the regulatory reforms put in place since the financial crisis.

National Archives of Singapore

This morning, I will do two things:

- First, take stock of the progress in making the global banking system safer.
- Second, highlight how we can ensure that banks continue to serve the needs of the real economy as we press ahead with the regulatory reform agenda.

Progress in Making Banks Safer

Let me start with the progress in regulatory reforms and their effectiveness.

Key Regulatory Reforms are in Place

Since the global financial crisis, regulators have put in place reforms to strengthen banking resilience and financial stability. There has been good progress in three key areas.

First, capital. Basel III imposes more stringent capital requirements and larger buffers to cushion against losses.

- Capital requirements have been enhanced for specific exposures, including market risk, complex securitisation, and counterparty credit risk, all of which were major sources of losses in the crisis.

Second, liquidity. Rules have been introduced to strengthen banks' liquidity risk profiles and promote funding stability.

Third, addressing the "too-big-to-fail" problem.

- Regulators have established frameworks:
  - first, to identify Global Systemically Important Banks (G-SIBs); and
  - second, to subject them to more intensive supervision, higher capital requirements, and resolution planning requirements.
- The Financial Stability Board (FSB) has set out key attributes for effective resolution, including the preparation of recovery and resolution plans for systemically important financial institutions.

Implementation Has Been Satisfactory But More Needs to be Done

Achieving international consensus on the key elements of bank regulatory reforms is laudable. But for the reforms to have their intended effect, *implementation* is crucial.

- The FSB has formed a Standing Committee on Standards Implementation to monitor the implementation of the financial reforms among its members
- I chair this Committee and so have particular interest in the issue of implementation.

National Archives of Singapore

The Basel III standards have generally been implemented in a timely manner.

- Basel III risk-based capital rules have been rolled out in all 24 FSB jurisdictions.
- Final liquidity rules have been issued in all but two jurisdictions.

In bank resolution, progress is more mixed.

- On the positive side, regulators have set up crisis management groups and developed recovery plans for all G-SIBs

  But significant work remains on operationalising these resolution plans.
- And not all FSB jurisdictions have bank resolution regimes that are in line with FSB's *Key Attributes of Effective Resolution Regimes.*

Implementing reforms in a timely manner is one thing; implementing them in a *consistent* manner across jurisdictions is another. Ensuring consistency and level playing fields, and

minimising opportunities for regulatory arbitrage have become the focus of implementation monitoring.

The Basel Committee conducts in-depth assessments of member jurisdictions' implementation of the Basel III capital standards to check for consistency.

- The United States and a number of Asian countries - including Singapore, Hong Kong, China and Japan were assessed to be compliant or largely compliant in their implementation of the Basel III capital standards.
- The European Union was, however, found to be materially *non-compliant*.
- As home to several of the largest global banks as well as important international financial centres, it is crucial that the EU shows leadership in ensuring more complete and consistent implementation of global banking rules.

Regulatory Reforms Have Generally Been Effective

The regulatory reforms have been largely effective in meeting their intended outcomes.

First, banks have become stronger.

- Banks are holding more and better quality capital.
  - Between 2009 and 2014, large, internationally active banks have *doubled* their average CET1 ratio from just under 6% to more than 11%.
- Banks are holding more liquid assets and have reduced leverage levels.
  - Since the crisis, the average liquidity coverage ratio for large, internationally active banks has risen from about 80% to more than 120%.
  - Leverage has fallen from around 22 times of equity to about 16 times.

Second, banks have become more resilient.

- Banking business faces serious challenges on several fronts.
  - The prolonged low growth, low interest rate environment has pressured net interest income.
  - Bouts of financial market volatility amidst a general contraction in market liquidity has increased the risks facing banks.
- But banks have held up well.
  - In the US, nearly all the largest banks have passed the Federal Reserve's most recent annual stress test.
  - In Singapore, an industry-wide stress test conducted by the MAS indicates that Singapore's banking system will be resilient against severe economic stress scenarios in the major economies and Asian region.
- And beyond the stress tests, the global banking system has remained relatively resilient through actual episodes of market stress in recent years:
  - the May 2013 US taper tantrum;
  - the Oct 2014 US Treasury "flash crash";
  - the Jan 2015 Swiss franc de-pegging;

National Archives of Singapore

- the Aug 2015 "Black Monday" selloff; and most recently
- the Jun 2016 UK referendum.

Third, bank lending to the real economy has been stable.

- Overall provision of credit to the economy has been maintained even as banks met higher capital and liquidity requirements.
    - According to the FSB, by the end of 2014, bank lending growth had resumed in all regions of the world.
- The cost of financing has not increased, although I suspect that this has had more to do with highly accommodative monetary policies.
- There has been no material shortage in the supply of long-term investment financing in most countries surveyed.

Ensuring that Banks Continue to Serve the Real Economy

While the effect of regulatory reforms on the broader economy has so far been benign, regulators must continue to pay close attention to the cumulative effects of various reforms and seek to minimise adverse consequences for the real economy.

Let me highlight two areas that bear close watching:

- First, profitability in the banking sector.
- Second, distribution of credit to key segments of the economy.

Bank Profitability is Important for Bank Stability

Let me start with bank profitability. Regulators are not in the business of ensuring profits for banks. But we have an interest in the profitability of banks for two reasons.

First, banks need to be profitable in order to be strong.

National Archives of Singapore

- Retained earnings are one of the major sources of equity, which is in turn the highest quality capital held by banks.
- Healthy capital buffers in turn improve the resilience of banks against losses.

Second, banks need to be profitable in order to be able to support the real economy.

- Banks have to earn a decent return on their credit intermediation role.
- A study by the Bank for International Settlements shows that banks with high capital ratios at the start of the Basel III process and strong profitability in the post-crisis years have tended to expand their lending more.

But post-crisis, bank profitability has come under pressure in a prolonged period of low growth and low interest rates.

- The banking industry's return on equity (ROE) has fallen significantly since the financial crisis.
- The average ROE of the 200 largest banks has fallen from 17% before the crisis (2005-2007) to 9% in the period 2011-2013.

Monetary policy, as it comes up against diminishing returns at the zero lower bound, is also not helping bank profitability. As policy rates are pushed into negative territory in a growing number of countries, the implications for financial stability need to be assessed carefully.

In a low or negative interest rate environment, banks are likely to engage in market segmentation and charge different rates to different groups of clients.

- Banks are reluctant to impose negative interest rates on retail depositors.
- This means that, to make up for the interest they have to pay on their deposits with the central bank, they may have to charge a higher interest rate on their borrowers.

High returns during the pre-crisis period were in part due to excessive risk taking or leverage, coupled with insufficient capital buffers against these risks.

- This has proven both untenable and perilous.
- A reduction in leverage and an increase in capital requirements are therefore desired outcomes of the reform agenda, to restore more prudent business practices and provide more sustainable finance over cycles.

But sustainability in finance requires that banks are reasonably profitable. Conversely, unprofitable banks are a potential source of instability.

- Poor profitability and low retained earnings will inhibit banks in building up their capital buffers.
- Without sufficient capital buffers, banks may be less willing to lend, which may constrain the availability of financing to the economy.

National Archives of Singapore

The Basel Committee is working hard at finetuning the Basel III capital rules:

- to reduce the variability in risk weighted assets applied by banks;
- to revise the standardised approaches for credit and operational risk; and
- to implement the leverage ratio.

But in the course of adjusting the capital rules to better achieve these outcomes, it is important that the *overall* capital requirements on banks are *not significantly increased*.

There is a real risk that overall capital requirements on banks could indeed increase significantly if we are not careful:

- if internal modelling for certain portfolios are completely removed; and
- if risk weights and credit conversion factors under the revised standardised approach are calibrated too conservatively.

We need to take a holistic perspective in this final stage of the Basel III capital reforms.

- In trying to get the design right, we must not end up making the overall level of capital requirements too high.
- In trying to get the micro calibrations right, we must not end up getting the macro settings wrong.

We have already achieved more or less the right level of capitalisation for the banking industry through the initial set of Basel III reforms after the financial crisis. If we now precipitate a further increase in the level of capital requirements in the process of adjusting the framework and fine-tuning the calibrations, it would unduly constrain credit intermediation and consequently economic growth.

We must guard against these unintended outcomes. It is therefore heartening that the Basel Committee has committed not to significantly increase *overall* capital requirements for banks.

Distribution of Credit Matters as Much as Allocation of Credit

Even as we hold the line on aggregate capital levels, we need to be sensitive to the effect of capital requirements on specific business lines and on different economies.

- This brings me to the second area that we should be watchful of: namely the distribution of bank credit across the economy as a consequence of regulation.

The Basel Committee will be finalising this year its review of credit risk capital requirements, as it seeks to address excessive variability in risk-weighted assets.

- The revisions to the capital standards for credit risk that are currently being proposed will require bank exposures to be risk weighted under a Revised Standardised Approach instead of the Internal Ratings Based approaches.
- The return to a Standardised Approach is motivated in part by limitations in risk modelling, as the last crisis laid bare. However, in avoiding excessive reliance on models, we must be mindful not to "*throw the baby out with the bath water*".

National Archives of Singapore

We should examine carefully the impact of these proposals on two areas, namely *trade finance* and *SME finance*. This is of particular significance for emerging economies.

- Across much of emerging Asia, where capital markets are relatively undeveloped, banks are a major source of funding for trade and SMEs.
- Trade and SMEs are major engines of growth in many emerging market economies.

Let me start with *trade financing*.

- Being short-term and self-liquidating in nature, trade financing is probably one of the safer forms of bank lending.
- But the proposal to move bank exposures completely to the Revised Standardised Approach could result in imposing significantly higher capital requirements for trade finance, more punitive than justifiable by its historical losses.

- While the availability and cost of trade finance have so far held up well in the face of Basel III implementation, the latest set of proposals could have the effect of discouraging banks from trade financing.
- This is not what we need at a time when trade is growing more slowly than income in many parts of the world.

Second, *SME financing*.

- I would say we are broadly on the right track.
- While SME loans tend to be riskier on a standalone basis, as a portfolio the risks are more diversified than loans to larger corporates.
- The Basel Committee recognises this and the current capital framework provides for preferential capital treatment for exposures to SMEs for banks using internal models.
- And the Basel Committee has further proposed applying a lower risk weight for banks' SME exposures compared to unrated corporate exposures under the revised Standardised Approach. This will help alleviate the cost of SME financing.

Conclusion

Let me summarise my main points.

We have made good progress in bank regulation since the crisis.

- Implementation has been generally good but some areas need more work and some jurisdictions need to close the gaps.
- Overall, the reforms have helped to make banks safer and more resilient.

As we finalise the Basel III capital reforms, we must ensure that banks are not only safe but also serve their purpose of supporting the economy.

- We should be mindful of the effects of low profitability on banks' ability and willingness to lend.
- We should be mindful not to increase significantly the overall level of capital requirements on banks even as we finetune the detailed capital rules.
- And we should be mindful not to unduly penalise lending to important segments of our economies – like trade and SMEs – even as we address the limitations in banks' internal models.

National Archives of Singapore

If we do this right, we would have made more progress than ever before – towards a banking system that:

- is safe yet purposeful, resilient yet dynamic;
- is robust in the face of business cycles and market volatilities, and supports economic growth and creates opportunities for individuals and enterprises.

Thank you.