BUSINESS EVENT BASEL CHAPTER

INSEAD

Alumni Association Switzerland

Special Report: Fireside Chat with Bill Coen, Secretary General of the Basel Committee for Banking Supervision, Basel Chapter, November 2014 -*The INSEAD Alumni Association invited Bill Coen, the recently appointed Secretary General of the Basel Committee for Banking Supervision (BCBS), to speak to Alumni and guests in October 2014. The audience, which hailed from a range of industries, engaged unreservedly with the affable American economist who spoke without props or Powerpoint at the old-style Grand Hotel les Trois Roi in Basel. The Basel Committee is a working group inside the Basel-based Bank for International Settlements (BIS). It sets global standards for banking solvency and liquidity. And the latest framework is referred to as Basel III, fitting since it comes on the heels of Basel II. It aims to encourage prudence amongst banks to save a standardized amount of money during the good times, to be ready for the inevitable down times, to improve transparency on solvency, and to evoke confidence in creditworthiness by introducing a universal standard leverage ratio metric that anyone can calculate and understand. He also described how his Committee is working closely with regulatory authorities around the world to improve consistency in implementation. The audience challenged Coen on accountability, values, unintended consequences, and complexity to which he responded candidly. Several times he intimated that it is too soon to conclude that the industry as a whole has achieved the ability to guarantee stability under extenuating circumstances, suggesting that the capital markets and the banks' shareholders will reveal the answer to that question. Coen also gave a short history of the BIS, without being shy about addressing controversial topics and the bank's "awkward moments".*

Bill Coen on Basel III: It's About Prudence, Transparency, and Creditworthiness

BASEL, Switzerland November 10, 2014 (INSEAD Alumni Association Switzerland) Anyone working in finance knows about the various Basel Committee standards which have been translated into regulations by financial authorities around the world. But for those who don't, right now we are on Basel III. Its goal is to improve the world's banks' resilience to asset and liquidity stresses and shocks. "We did not want to call it Basel III, but it is apparently easier than referring to it as 'International Convergence of Capital Measurement and Capital Standards'," said William (Bill) Coen, Secretary General of the Basel Committee on Banking Supervision who spoke at a recent INSEAD Alumni business event in Basel.

His committee of 45 men and women basically has the task of trying to get banks to save for rainy days, to not borrow more than they can pay back with alacrity, and to practise banking with transparency and comparable numbers.

Practicing Prudence

Coen said that the Basel III framework is meant to address weaknesses in Basel II uncovered during the credit crisis of 2008. "Disclosures are being improved. Rules are being simplified," said Coen. It was important to us that disclosures be comparable, and the requirements risk-sensitive.

The greatest achievement with Basel III was getting central banks and supervisory authorities to agree on the size of capital buffers big banks must hold. "The type of capital that has to be held has improved too," said Coen. "Banks [also] had a vast array of buffers," said Coen.

"We have had thirty years of trying to establish a global minimum liquidity buffer. We have one now," said Coen. Prior to Basel III, there were no global bank standards for liquidity or funding.

The idea of increasing banks' capital buffers at the very time when they want to continue to invest and therefore expand was one cause of resistance. Furthermore, banks don't like to hold capital bases that they could be investing.

The technical name for saving money during growth and expansion, pro-cyclically, is "Macro Prudential Buffer". In practical terms, the banks build up a capital buffer of a certain percentage during up times -- to be ready for the economic downturns or unexpected events. "There are peaks and troughs in any market. Banks need to be building capital buffers to protect against the inevitable downturn," said Coen.

Commenting on the prospects for global implementation and effectiveness, Coen exhibited humility. He said, "It sounds great in theory. We will see how it works in practise. The jury is still out."

Leverage Ratio Consensus

The second big achievement in Basel III is the establishment of a universal "Leverage Ratio" standard. It is a simple calculation of equity as a percentage of a bank's assets and off-balance-sheet exposures (for example, commitments to lend money). As such, it could be a more straightforward and comparable measurement. "The Leverage Ratio is seen as less vulnerable to manipulation," said Coen. The new minimum ratio is 3.0%.

Despite it being more transparent than other measurements, the Leverage Ratio has been one of the more controversial things the Committee has ever suggested. It has never been part of the framework in EU and Switzerland, for example, although the US had it, even before the credit crisis.

Coen said that critics like to suggest that despite having a Leverage Ratio, the credit crisis was not averted in the US: banks still failed. "I would venture to say that, in support of the LR, Ben Bernanke would argue that the losses the US banks experienced would have been much worse had the banks *not* been subject to a leverage ratio," said Coen. In other words, the US believes its leverage ratio played an important role in saving the banking system. It is worth noting that the current leverage ratio desired for US banks is 6.0%, according to Coen.

The Leverage Ratio also contrasts with Basel II's data-driven risk models. Basel II was highly criticized due to its complexity because it tried to capture banks' risk so they would not be vulnerable to massive losses using an array of models for disclosure purposes. "We tried to differentiate the risk in Basel II. That is why the bank's models are so necessary and important. The riskier the asset the more capital they have to hold," said Coen.

When Coen refers to complexity in the context of Basel II, it is the models that are considered complex, as well as the standard itself. It is 347 pages, according to INSEAD Knowledge in contrast to Basel I, which was only 28 pages in length. "That was a simpler time," said Coen, implying that the rules had to be complex because the banking system has become incredibly complex.

There is a "raging debate" if models should even be used for regulatory purposes. The bank supervisors are supposed to assess the banks' models – if they have the right data services, for example. JP Morgan experienced high-profile losses because it was using a risk model approved for another part of the bank, according to Coen. The Leverage Ratio is an antidote to that kind of weakness. "We don't care about risk as far as the leverage ratio is concerned," said Coen.

Stress Tests and Too Big to Fail

The third achievement of Basel III is a methodology for assessing the shock-absorbency of global systemically important banks (G-SIBS), as well as domestic systemically important banks. So far there are 30 banks identified as G-SIBs, which many consider too big to fail, such as Deutsche Bank, Credit Suisse, UBS and Bank of China. “We would never say that they are too big to fail,” asserted Coen, but what is agreed upon is that they would cause a major disruption if one of them failed. “It would it make it very hard to wind down in an orderly way,” said Coen.

G-SIBS have even higher capital requirements than other banks. “There are some banks that think it is great to be a G-SIB. Take funding for example, counter-parties are far more relaxed about doing business with a G-SIB,” said Coen.

Banks are now subject to stress test reviews and the results of the tests are released publicly - to shareholders, peers, media, industry analysts and regulatory bodies. The latest stress tests in the EU revealed that 25 banks failed to pass.

As some banks are exposed as too weak, it will likely result in more banking industry consolidation activity. On a national level, well beyond the realm of the Basel Committee’s influence, there will likely be a process to roll the “healthy” assets of the weak banks into a new entity and sell off the “bad” assets at a discount. There is already evidence of that in some countries, according to Coen. Speculation is that some very old banks will eventually be wound down, particularly in Italy.

Strength in Diversity

Another recent development with the Basel Committee is that it is now much more diverse with representatives from 27 nations, including Emerging Market countries. How do you find common ground with 27 countries, asked a member of the audience. “The one common principle is prudential safety and soundness. Business and economic cycles are different and levels of complexity are different but one common principle is prudential safety and soundness,” responded Coen. Agreement is reached by consensus rather than a majority “Yes or No” vote.

The Committee had only 13 countries represented until 2009 but has since doubled the size with new members and observers, many from so-called Emerging Markets, such as central banks in UAE, Malaysia, and Chile. “They have all been through crises. They all had lessons learned from crises and crisis management. This adds an important dimension,” said Coen, adding that for example, they “wholeheartedly agree” with a Leverage Ratio. Other values, include protecting financial systems, protect taxpayers and depositors, and avoid losses of taxpayer money.

Supervising the Supervisors

When Basel II came out in 2004, it aimed to improve the measurement of credit risk and expose operational risk. The Basel Committee expected that each country would implement the rules, and they did, but there were variations. “No two countries did it the same way,” said Coen, adding that key features “got lost in translation”. Now there is a process in place to monitor implementation. “We follow up on local adoption almost line by line. We don’t have any enforcement or sanctions, but we publish the results of our country reviews,” said Coen.

One member of the audience asked Coen about the notion that regulatory requirements of Basel III for certain financial instruments could force banks to unnecessarily begin unwinding trades,

just to meet regulatory targets, and trigger a massive panic in the market. Coen responded such "Doom Loop" scenario and "fire sale" ideas are overblown. "What you are referring to is only one part of the bank's book, the trading book… There is preventative protection built in elsewhere in the standards," said Coen.

Questions and conversations continued over drinks and a light dinner afterwards. Event organizer, Steven Morales de Medrano, CIO De Medrano Wealth (DMW), said that the event was ten months in the making and worth the effort because Bill Coen came highly recommended for his technical skill, human character, and ability to communicate with audiences. "He devoted plenty of time for Q&A, which helped shape the event as much as possible to the interests of those present," said Morales, adding that level of audience participation was high, and he'd like to invite that same audience back for more events!

It is quite likely that another event on "Too Big To Fail" regulatory policies will be planned due to their relevance to the safety of the financial system, and all of the innovation and good ideas emerging from crisis-preparedness work.

Five Things You Didn't Know about the BIS

1. Assets and Accountability – The managers of the bank's approx. CHF 318 billion Assets under Management is accountable to the Board and its 61 shareholders (mainly central banks) who have voting rights commensurate with share ownership. BIS invests their deposits for them, gives them a return, and keeps a little bit for itself (see point 2). Read more on the balance sheet.
2. A Bank and a Think-tank. The bank's bankers earn the money, and the various working groups spend it on massive amounts of research and analysis that is available publicly.
3. Tons of Gold. Fourth largest gold reserves world-wide (111 tonnes stored all over Switzerland at 31 March 2014)
4. Out of Reach of Politicians & Dictators. If there is a change in government, it cannot demand the deposited money back without a legal process. This has been tested recently. In a sense the BIS protects national wealth through central bank independence. BIS is granted immunity by and from the Swiss Government, which is recognized in international courts, particularly in The International Court of Justice in Den Haag.
5. Central Bank Owned. Some shares were made available to the public several years ago and were in private sector hands but the BIS bought them back and it says it is now truly a central bank-owned entity.