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Maintaining consistent supervision and risk-sensitivity at the core of the Basel framework

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The capital framework for banks and the banking system as whole has evolved significantly since the creation of the Basel Committee on Banking Supervision some 42 years ago.

A financial system previously dominated by banks with large banking books undertaking core lending activities has evolved into an advanced financial system with a sophisticated range of financial instruments. This evolution in the financial system has powered the growth and globalization of the world economy, created new saving and investing options, and enabled companies to effectively manage the varied risks that they face.

As the banking system has evolved, so too have the capital rules to ensure that risks within the system are adequately capitalized.

As one would expect, this has led to important changes over the years and naturally the framework will continue to evolve. But as the framework does evolve, it will be important not to lose sight of three key principles that are essential to an effective capital framework.

First, banks need to have adequate levels of capital to effectively manage the risks that they face and for banks themselves not to pose risk to the wider financial system.

Second, a close link needs to be maintained between risk and the allocation of capital.

Third, the capital framework should be underpinned by an effective supervisory framework which ensures rigorous risk management, and leads to consistent outcomes in risk weights not only across products but also across jurisdictions.

Three key principles that are essential to an effective capital framework.

As we look forward, we are at a point where we run the risk of breaking the link between capital and risk and the central role of supervision – instead of standardized measures – as the key driver of consistency in risk weights is being lost.

A risk-sensitive capital framework is essential to ensure appropriate incentives are permeated throughout firms. It also plays an important role in driving economic growth and helps to minimize the misallocation of resources.

Requiring all banks to use the same simple, standardized models will encourage a mechanistic reliance on those models, which may result in herd behavior during periods of market stress as banks take the same actions to meet regulatory capital requirements.

Moreover, there is a risk that too much capital relative to the risk being undertaken becomes trapped within the banking sector, stifling vital activities and hampering economic growth.

As we look forward, we need to maintain risk sensitivity in the prudential rules and rigorous and consistent supervisory oversight to ensure that risks are being effectively managed and the financial system is serving to help grow the economy.