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Bank of Japan

Remarks at the Institute of International Finance Annual Membership Meeting

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Introduction

It is an immense pleasure for me to be able to speak to you at this year's annual membership meeting of the Institute of International Finance.

As you know, the Bank of Japan introduced "Quantitative and Qualitative Monetary Easing," or QQE for short, in April. Consequently, positive developments in the Japanese economy have become increasingly pronounced, and the outlook is perhaps brighter than at any other point since the turn of the century. I could obviously go on, but considering that I have already spoken extensively about the macroeconomic picture in Japan in the last few days, let me today focus on a different subject: the future of international regulation and supervision of financial activities.

The Crisis and Responses

All of you in this room today would agree with me in saying that the defining event of recent years was the Great Financial Crisis. That Crisis shook the foundations of international regulation and supervision of finance. Before it occurred, everybody thought that the interests of bankers and of regulators and supervisors were more or less aligned. If we promoted better risk management at banks, banks, out of self-interest, would become much safer, which in turn would enhance the resilience and robustness of the international financial system.

Unfortunately, that was not the case. The fact that the existing framework of regulation and supervision did not prevent the worst financial crisis in perhaps a century from occurring, taking the real economy to the edge of the abyss, prompted regulators and supervisors to take a long hard look at what they had and had not achieved. The result is reform of the international regulatory and supervisory framework, the initial results of which we are already observing today. The Basel III capital standards have already come into force in many economies including Japan. I hope that some major economies which are experiencing delays soon catch up. We have also strengthened the regulation and supervision of global systemically important financial institutions, or G-SIFI's.

We have indeed made progress. However, what we have done so far is to patch up the leaks in the roof. The next steps are crucial.

Critique of the Basel Standards

The Basel Standards have now existed for 25 years. The risk-based capital charge, which is the centerpiece of the Standards, has evolved over this period. In the beginning, there was only credit risk. Now the Standards also cover market and operational risks. The Standards have also become more risk-sensitive, including the recognition of model-based approaches for measuring risks. Having said that, I must also admit that we are now hearing increasingly vocal criticism of the Standards. Influential critics, brandishing the fact that the Standards did not prevent the Crisis from occurring, are saying that the patchwork of rules that have evolved over the years has become overly complex, and that simpler metrics, such as the leverage ratio, might be more effective than the current Standards in preventing crises. If I may continue with my house analogy, these commentators seek to persuade us to move into a new house, instead of continuing to renovate and live in an old house.

Before I present my own case, I should admit that the Basel Standards are not perfect. First of all, risk and uncertainty are different. In a world where uncertainties abound, we measure risks at our own peril. As a result, any risk-based regime is inevitably confounded by black swans.

Second, there is the problem of model risk, which is a point related to the first. Even if we could put uncertainties aside, models, being approximations, can never perfectly trace what happens in reality. If models err on the side of caution, too much capital will be demanded of banks and the economy will suffer from a lack of financing. The opposite could also be true.

Finally, procyclicality could undermine the effectiveness of a risk-based framework. Risk measurement tends to present a rose-tinted picture when the economy is on a roll. That, in turn, prompts banks to take more risk, when they should be building up their buffers for a rainy day. When the economy turns south, the whole process goes in reverse and the economy is strangled by the rush to delever.

All of these points are valid, but they are not fatal flaws. They can be overcome by prudent regulators and supervisors. In fact, reform efforts, most notably the Basel III package, are clearly responses to these critiques. Regulators and supervisors are dealing with uncertainty by introducing more conservative assumptions and parameters for risk measurement, and also by conducting stress tests. They are putting enormous efforts into calibrating regulatory frameworks and reviewing models employed by banks in order to minimize the effects of model errors. Basel III has introduced the countercyclical buffer and mandated stress-period parameters in order to mitigate procyclicality.

Towards Better Regulation and Supervision

Regulators and supervisors must listen to the critics, but they need not abandon the basic framework of what they have been doing.

Banks face various risks in their day-to-day business. Common sense tells us that banks should be assessing these risks to the best of their ability. It should then follow that banks need to hold sufficient capital to cushion themselves from any adverse consequences when those risks materialize. In this sense, regulators and supervisors can and should not lose faith in the concept of risk sensitivity. Meanwhile, risk measurement practices should more or less converge among banks that are active in the increasingly borderless global financial market. Capital regulation focusing on such measurement is not only sensible, but is perhaps the only viable framework which can achieve adequate international consistency. Accordingly, I believe that risk-based capital charges should remain at the center of international financial regulations.

Of course, there are caveats. One important one is that we should resist the temptation to read too much into capital charges. Risk measurements are always approximations, and variations are inevitable. Consequently, while we should make every effort to maintain the consistency of measurement among banks to maintain confidence in regulation, we should at the same time refrain from placing too much emphasis on decimal point differences in the capital ratio.

The key is to take a balanced and nuanced approach.

Final Thoughts

Regulators and supervisors must be humble about the usefulness and effectiveness of regulatory standards and rules. Risk-based capital standards should remain at the center, but other approaches must complement them in areas where capital charges cannot adequately address problematic behavior among banks. Though I do not have time to elaborate, tough and effective supervision is also very, very important.

The simple leverage ratio may be a good metric in some respects, and is a useful complement to risk-based capital ratios. Nevertheless, once it is asked to stand on its own as the global financial system evolves, a system whose advantage is simplicity could well become more complex and lose its advantage as regulators and supervisors try to accommodate real-world idiosyncrasies. It may just be that the grass looks greener in front of the house for sale next door.

Navel-gazing can sometimes be useful, but today, in the context of regulating and supervising international financial activities, our priority should be to implement as quickly as possible responses reflecting the lessons of the Great Financial Crisis. In this process, it is most important to maintain the international consistency and homogeneity of national regulations, the lack of which may well undermine the stability of the international financial system. As we then learn from operation of the new rules, including their effects on the real economy, we should begin discussing how to improve the rules and standards further. The Bank of Japan is ready to contribute to this process.

Thank you for your attention.