Klaas Knot: Want a strong financial system? Implement Basel III

Speech by Mr Klaas Knot, President of the Netherlands Bank, before the International Institute for Banking Research (IIEB), a group of European bankers, Amsterdam, 11 October 2024.

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Thank you Ralph, and thank you for the invitation to speak here before this distinguished audience.

You are all leaders of big organisations. So you are familiar with the question of strategic change: how do you navigate your bank through the waves of financial market sentiment, changing consumer preferences and technological innovation? A sound strategy starts with a lot of thinking, for sure. Strategic thinking. Board room discussions. A couple of consultants perhaps.

Finally there is a strategy. A Strategy with a capital S. You know where you want to go and how. But now you enter a crucial phase: implementation. How do you get all corners of your bank from A to B? Because all the strategic thinking in the world will come to nothing if your bank does not follow suit. Implementation is key.

So how would you feel if, after 13 years, your plans are still stuck in the implementation phase? I ask because that's the situation we are in with Basel III. When I became governor back in 2011, we were discussing the implementation of Basel III. And now, towards the end of my second term, we are still discussing the implementation of Basel III.

By now, some of you might think: 'ok, so this morning we got war for breakfast, and now for lunch we get a central banker who wants to talk about the rules. What's next? We've heard this scratchy old broken record dozens of times before!' But, as you know, these are often the best records.

So let me take a step back here. Where are we coming from? In 2010, the Basel Committee on Banking Supervision introduced the first set of Basel III standards. A set of international rules designed to fortify the global banking system after the worst financial crisis since the Great Depression. These reforms were not just a patch-up job. They were a complete overhaul of banking regulation to improve bank resilience, transparency, and risk management. Basel III focused on increasing capital adequacy, introducing the leverage ratio, and creating more stringent liquidity requirements. With the memory of the crisis still fresh, national implementation of this first part of Basel III went relatively quickly.

This first set of standards was then complemented in 2017 by the final Basel III standards. They focused on enhancing the risk-weighting framework, introducing more robust capital floors, and limiting the variation in banks' internal risk models. These standards, by now famously known as the Basel endgame, have not yet been implemented by jurisdictions around the world. The EU, in its implementation, deviated on important points, making banking regulation weaker than agreed in the new standards. In the US and the UK, initial legislation proposals have also been weakened,

with some elements not fully aligned with the Basel III agreement. Legislators also point at each other when making these adjustments. US banks spent tens of millions of dollars on a lobbying campaign that included ads in the middle of American football games. I don't think it's ethical to interrupt football games for any kind of message, let alone on Basel III.

But on a serious note: our failure to implement fully what had already been agreed upon back in 2017 should be worrying. Not only to me, as a regulator, but also to you, as bankers. To explain why, let me give you my version of a pro-Basel lobbying commercial.

Implementation of Basel III will increase the credibility of capital ratios and strengthen the banking sector. Think of it as a safety net, your safety net. It will ensure that when the next economic shock comes-and it will come-you will be better prepared to withstand it. The capital buffers required by Basel III are not a burden; they are a shield, allowing you to absorb losses while maintaining operations, protecting your customers and preserving your reputation in times of stress.

Many in the banking sector view regulation as a constraint, something that limits profitability and imposes undue costs. But it's just the other way around. Basel III is not an obstacle to growth, it is an enabler of sustainable, long-term growth. Banks with strong capital positions and sound liquidity management are better positioned to extend and rollover credit, invest in new technologies and fund large-scale projects. They are better able to maintain lending during an economic downturn. And stronger banks can secure more favourable funding conditions, attract long-term customers and build partnerships that increase shareholder value.

Basel III works best when it works everywhere. When Basel III is implemented unevenly across jurisdictions, it creates a patchwork of regulations that opens the door to regulatory arbitrage. Banks may be tempted to shift operations to regions with looser standards. Consistency across borders is not just in regulators' interests-it's in yours as well. An uneven playing field undermines confidence in the global banking system, disrupts competition, and ultimately increases systemic risk. It puts banks at risk of operating in jurisdictions where regulatory frameworks are not equipped to deal with crises, leaving you exposed when things go wrong.

By contrast, global implementation of Basel III creates a level playing field, ensuring that all banks-no matter where they operate-adhere to the same high standards. This uniformity strengthens global financial stability and, in turn, enhances the confidence of your shareholders, customers, and counterparties.

The opposition to Basel III reflects a kind of short-term thinking, that, frankly, I find hard to understand. Weakening of Basel III may give you a few basis points in capital relief, but it exposes you to long-term vulnerabilities. As the memory of the global financial crisis fades, we risk entering a race to the bottom. A race that would be very dangerous for financial stability. Or, as Daniel Davis said in his much-quoted Financial Times article, 'while the road to hell is paved with good intentions, the road to the next banking crisis is paved with good exemptions.'

So in short, it is essential to implement the Basel III standards in all jurisdictions. Not least because, as you know, financial markets are not waiting for us to learn the lessons of 13 years ago. New risks are always emerging, as the events in March last year showed. The demise of Silicon Valley Bank and Credit Suisse not only brought lessons for banks and supervisors. They also highlighted that we may need some targeted changes in banking regulation beyond Basel III. I want to mention three areas here: liquidity, interest risk and AT1 instruments.

First on liquidity. Partly as a result of social media and digitalisation, the outflow of deposits at SVB was much faster than in previous cases, and much faster than LCR calculations take into account. This raises the question of whether the LCR should be calibrated differently for certain types of deposits. The aim would be to increase banks' resilience and provide incentives to attract longer and more diversified funding.

Another avenue which should be explored in the light of the SVB case is whether unrealised losses should be better reflected in the capitalisation of banks. Here I'm referring to the difference between market and book value for bonds which are held to maturity. And we should look at how to address the issue that, in times of stress, banks may be hesitant to use instruments in the liquidity buffer that are not marked to market daily for accounting purposes.

The turmoil last year also showed how important it is that banks are operationally prepared for liquidity stress. Banks need credible and tested contingency funding plans and they must be operationally ready to access central bank liquidity facilities in times of stress. While this may be more of an issue in the US, we should also look at how this can be improved in the EU.

Then interest rate risk. When banks fail to cover this risk sufficiently, changes in market interest rates can lead to substantial losses and, in extreme cases, even to bank failure. The recent developments at regional banks in the US offer a vivid illustration of this.

The events last year underline the importance of regulation for interest rate risk management and the need for prudent assumptions about customer behaviour. Capital is also necessary to absorb the uncertainty of customer behaviour. In order to promote global harmonisation, we should explore the inclusion of interest rate risk in the Pillar 1 requirements.

And last but not least, we need to think about AT1. Rather than acting to stabilise a bank as a going concern in stress, international experience has shown that AT1 absorbs losses only at a very late stage of a bank failure. We saw this in the case of Credit Suisse in 2023, with the Swiss National Bank noting that 'the AT1 features designed for early loss absorption in a going concern were not effective'. In this instance, AT1 only absorbed losses when the point of non-viability was imminent and failed to stabilise the entity at an earlier stage of stress. This should encourage regulators to reflect on the role and functioning of AT1 instruments in determining the capital position of banks.

These are all important things that we have to look into. But first and foremost we have to implement Basel III. And while I know this is primarily a message to regulators and

lawmakers, it is also a message to you. Because what a strong signal it would be if you as a group would say: don't water down Basel III. Don't give us weak rules, give us strong rules. Strong rules that apply to all banks wherever they are and whatever their size. It would not only be a strong signal to us, regulators and lawmakers, it would also be the rational thing to do. Because strong rules are in your interest. Because a strong financial system based on a level playing field is in your interest. Because regulation is not a constraint on the financial industry, it is a license to operate.