Conclusion: Is Basel Best?

The crisis has changed banking. Even if the recovery takes hold, the days of “heads the bank wins, tails the public loses” are over. There will be no return to the pre-crisis regime. What will take its place? The Basel regime (less likely to fail, safe to fail) described in this book, or some other?

The Basel regime will enhance financial stability

The Basel regime is well on its way to implementation. Basel III has greatly strengthened regulation. The accord has prompted jurisdictions around the world to raise capital requirements, introduce liquidity requirements and set standards for governance and remuneration. This will reduce the likelihood that banks will fail.

So will efforts to sharpen supervision. In major jurisdictions around the world supervisors are becoming more forward-looking and more pro-active, both in monitoring banks and in intervening to keep banks away from the point of non-viability. Stress tests are playing a key role here – supervisors are insisting that banks have a capital buffer that would enable them to withstand a significant deterioration in economic conditions. As a practical matter, this has accelerated banks’ compliance with the tougher capital standards imposed by Basel III. In sum, sharper supervision has complemented stronger regulation. Together, they reduce the risk that banks will fail.

There has also been extensive progress in making banks resolvable, or safe to fail, so that investors, not taxpayers, bear the cost of bank failures, and so that banks can continue to perform critical economic functions, even whilst they are
in resolution. The FSB has identified the key attributes that resolution regimes should have, and jurisdictions around the world have taken steps to introduce such regimes. This establishes the framework in which effective resolution could take place.

Resolution plans translate the general framework into institution-specific blueprints that the authorities could follow, if the bank in question were to reach the point of non-viability and enter resolution. Broadly speaking, these plans indicate that banks can be made resolvable. Through bail-in investors could recapitalise the bank at the point of non-viability. That would assure the solvency of the bank-in-resolution and set the stage for it to obtain the liquidity it will require in order to continue in operation and to continue to perform critical economic functions.

To assure that this framework will actually function as designed, banks and the authorities will need to take three steps in advance. First, if investors are to recapitalise the bank at the point of non-viability, the bank must have a certain minimum amount of “reserve capital” outstanding. Accordingly, authorities are considering imposing requirements that banks issue “gone concern loss absorbing capital” (GLAC). Second, for the bank-in-resolution to obtain liquidity, it must have unencumbered assets that it could pledge to the liquidity provider as collateral. As part of liquidity regulation, banks will be required to track and report such assets. However, banks and authorities need to spell out in greater detail how the bank-in-resolution could in fact utilise such unencumbered assets to obtain liquidity. The first two steps would go a long way toward enabling the authorities to complete the third, namely, the establishment of “constructive certainty” about how they will work together to resolve a global banking group.¹

These are doable tasks. But banks and the authorities need to stay the course if they are to secure the prize of making banks resolvable and thereby enhancing financial stability.