Banking Regulation- looking back and looking ahead[1]

Your Excellencies, Distinguished Guests,
Sabah-al-khair and a very good morning.

I am very delighted to return to this forum, and I am grateful to H.E. Dr. Abdulrahman A. Al Hamidy for inviting me to speak before this august gathering.

Thanks to the active collaboration of the Basel Committee on Banking Supervision, Financial Stability Institute, and the Arab Monetary Fund, this event has become a valuable forum to discuss issues that are relevant for the region, and exchange ideas on key financial sector developments.

As this year marks the 10th anniversary of the global financial crisis, it is fitting to reflect upon the past, assess where we stand at present, and consider what lies ahead of us.

Looking back

Let me start with the past.

A decade back, few had imagined that a subprime mortgage crisis in the US would soon engulf a major part of the global financial system. As we all know now, the financial meltdown that followed had serious economic consequences; global output sharply declined, growth significantly slowed down and unemployment soared across the world, particularly in advanced economies.

Globally, cumulative output loss since the GFC has been a hefty 25% of the world's GDP; these estimates don't include the social costs associated with high unemployment and lost output. Within the US alone, around nine million jobs were lost, and eight million homes were foreclosed. In many countries, public at large felt abandoned, as income inequalities widened.

Equally significant for the financial services industry was the loss of public trust. Ethical drift and poor incentive structures led to a range of violations, from widespread mis-selling of mortgages to manipulation of LIBOR, that not only undermined the public confidence in the financial sector, but also caused a huge reputational loss.

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[1] Keynote speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait in the 13th High Level Meeting for the Middle East & North Africa Region, jointly organized by the Basel Committee on Banking Supervision, the Financial Stability Institute and the Arab Monetary Fund, held on December 13, 2017 in Abu Dhabi, UAE.

The exorbitant costs of the GFC, both monetary and reputational, prompted global community to work together in restoring financial sector stability.

What we have achieved so far

Ten years on, and the journey of building a resilient financial sector still continues. Nonetheless, thanks to the efforts of the global regulatory community, significant safeguards have been put in place to mitigate the risk of a similar crisis in the future.

Though banks in the MENA region were generally well capitalized and prudently regulated, regulators across the region have further refined their existing regulations along with the implementation of Basel III reforms.

For instance, capital adequacy regime has been enhanced, with higher and better quality capital. Additional *capital conservation buffer* and *countercyclical capital buffer* requirements have also been put in place to help banks maintain additional cushion and limit the buildup of systemic risk. Likewise, *leverage ratio* has been phased in as a backstop to CAR. And the implementation of *Liquidity Coverage Ratio* and *Net Stable Funding Ratio* have further strengthened banks' capacity to withstand liquidity stress and to make their funding structure more stable.

Thanks to these regulatory reforms, banks in our region entered the low oil price environment from a position of strength. Reflecting the impact of the drop in oil prices, fiscal deficit for the MENA oil exporters has surged from 1.1% of GDP in 2014 to 10.6% of GDP in 2016. Yet there are hardly any major signs, at least so far, of deterioration in banks' resilience in general – despite the fact that banks are in this low oil price environment for over three years now.

Indeed, the degree of resilience varies from country to another. Yet the broader presence of financial sector stability across the oil exporting countries underscores the fact that banks in these economies have weathered the oil rout quite well. This would not have been possible without strengthening our regulatory regime and building buffers in benign times.

Even the concern that increasing burden of regulations might reduce banks' capacity to lend appears unfounded. For instance, while banks' minimum capital requirement has increased, we have not observed a noticeable impact on the availability of credit. Financial Stability Board has also made a similar observation.

In fact, the soundness of our banks has not only helped them weather a challenging macro environment, but has also enhanced their capacity to deliver on their primary objective of credit intermediation.

What lies ahead of us

While a great deal of progress has been made, reforming regulations is a continuous process, a journey rather than a destination.

So we need to consider what lies ahead of us.

First, we should take stock of what we have already put in place, determine the effectiveness of our measures, and examine if there are any unintended consequences. We need to assess if our regulatory reforms have been over or under done; whether we are too stringent to stifle innovation, or too lax to ignite instability. And despite the wide-ranging reforms, possibly some of the risks are still not adequately captured.

Consider the current risk charge for operational risk under Basel III. In recent years, the scale and sophistication of cyber-attacks have increased significantly; hardly a month passes without the news about a major breach in personal data affecting millions of customers. For instance, a cyber-attack on Equifax, a credit reporting firm, compromised the private data of 143 million customers in the US. Despite the increasing scale and sophistication of cyber-attacks, banks continue to treat such risks the way they used to do so a decade back. At least this is our impression by looking at the risk weighted assets reported by our banks which barely reflect the true scale of operational risk they face today.

Second, as we assess the adequacy and effectiveness of our new regulations, we need to examine if potential benefit of greater financial stability truly justifies banks' cost of compliance with new measures. In setting prudential limits, we can't simply follow a 'higher-the-better' rule. After all, we don't want to be just resilient. We want to be '*efficiently resilient'*. We aim to design and build a regulatory regime that, at best, helps avoid any financial turmoil, and at least limits the very potential of even the buildup of a crisis. And in doing so, we need to justify the costs that new regulations entail.

This brings me to the third point of *proportionality* in regulation. Cost of compliance does vary across institutions, as larger banks enjoy economies of scale. Moreover, with the increasing complexity in regulation, smaller banks might be at a disadvantage, which has implications for competition in the banking sector.

So our regulations need to be not only commensurate with the risks, but also with the sophistication of the institutions involved. While many of the regulations have a degree of proportionality already embedded, there is some scope for further reducing the compliance costs for smaller banks. However, every regulator needs to carefully consider the costs and benefits in their own domestic context as no one size fits all. In the end, as Einstein put it, it is desirable to '*make everything as simple as possible but not simpler'*.

Fourth, supervision needs to play its part as regulations alone can only go that far. It is effective supervision that enables us to vigilantly examine banks' performance and gives us the agility to mitigate emerging risks before they materialize. It is also easier to adapt our supervisory approach to evolving risks instead of constantly tweaking the regulatory rulebook. So we should continue to reexamine our supervisory toolkit and build our capacity.

Fifth, with the growing footprint of financial technologies, we face a delicate act of balancing the risks and rewards coming from innovations. In principal, we need to regulate innovations in an *enabling* and *proportionate* manner, using a tiered process of introducing rules in accordance with the risks involved. That is why regulators are increasingly adopting a 'regulatory sandbox' approach to provide a testing ground for innovative products or services. This approach would help harness the potential of innovative technologies without exposing the entire financial system during the early stages of exploration and development.

To conclude, I am pleased to be here, as this forum provides a valuable platform to discuss issues of mutual concern. With the rapidly evolving nature of banking and financial markets, we can't fully predict what will come next. Therefore, we, the regulators, need to be, as Churchill said, 'awake to the tips of our fingers'.

Thank you for your attention.

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