David Clementi: Current Threats to Global Financial Stability - a European View

Speech by Mr David Clementi, Deputy Governor of the Bank of England, to the British-American Chamber of Commerce, New York, on 22 January 2001.

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Introduction

It is a great pleasure to be here in New York. I was last at a British Chamber of Commerce meeting towards the end of 1998 when I talked about the readiness of London for the arrival of the euro. My message then - that while the UK might be outside EMU, the City of London was very much part of the Euro area - has been borne out by events. London remains by far the largest financial centre in Europe and the most international. Nowhere has a larger concentration of foreign banks, or greater daily turnover in foreign exchange and derivatives or trading in foreign shares. And much of the new business in euro is conducted through London. The majority of euro-denominated debt is issued in London; and more than a third of deals on the London Stock Exchange take place in euro. US financial organisations, many of them represented here tonight, make a significant contribution to this success.

This evening I would like to address two rather different subjects. The first is to reflect on recent developments in the US economy and the potential impact this has for the UK and for the stability of the financial system more generally. I would then like to say a few words about the proposed revisions to the capital requirements for international banks, announced last week by the Basel Committee; not just because it is topical but also because these capital requirements are central to the stability of the system and its capacity to withstand shocks; and as cautious central bankers it is important to take stock from time to time.

US & UK Economic Ties

As a very open economy, and one with close trade and investment links with the US, especially in the financial sector, the UK is a keen observer of events here.

While much has been made in recent years of globalisation, the links between the US and UK are long-standing and deep-rooted, not least in the financial sector. For many years US financial institutions have been among the biggest players in the City. US firms take the top three positions in London as bookrunners in international bond and equity issues, and as arrangers of syndicated credits. Through their dynamism and innovation, US firms also play a major role both in maintaining London's pre-eminence as an international financial centre and as a potent force for strengthening the competitiveness of the UK's own financial institutions. Our interest in the continued financial strength of US firms is thus clear.

Foreign banks are similarly active in US markets. For example, they account for 40% of the US syndicated loan market regularly surveyed by the Fed. UK banks, in particular, have sizeable direct investments in the US and large cross-border exposures to US banks and corporates. Cross-border exposures to US non-bank borrowers stand at around $62 bn, more than 50% higher than the equivalent exposures to the rest of Europe, while the total exposure of UK banks to the US amounts to $110 bn, or 8% of UK GDP. Close ties in financial markets parallel the strong links in other sectors. Whether it is Grand Met seizing the Pilsbury Doughboy or Ford making off with Jaguar and Aston Martin, there has been a significant and increasing flow of direct investment in both directions across the Atlantic. The close correlation between movements in the FTSE and Dow is testament to the links between the US and UK corporate sectors.

Given the strength of these ties, UK banks and investors are inevitably vulnerable to a US slowdown. The scale of UK exposures to the US helps to give some dimension to the scale of this risk. An analysis based on the market ratings of borrowers suggests that the statistically expected annual losses on UK bank's exposures to the US are likely to be around $1bn or about 1% of UK exposure. In principle, banks should have fully anticipated these losses in their loan pricing and general provisioning. But bank capital is there primarily to absorb unexpected losses, for example the consequences of an unexpectedly deep US recession. I will return to banks' capital adequacy later but first I want to say a few words about our perception of the US economy and the implications for the UK.

US Economy: Soft or Hard Landing?

The dramatic improvement in US economic performance through the 1990s, in terms of growth and productivity, gave rise to a sharp increase in expected returns to investment and, as a result, increased domestic and foreign demand for US assets. Investment has been particularly concentrated in ICT (information, computers and telecommunications), much of it financed by borrowing on the strength of projected future profits.

However, growing uncertainty over the size and permanence of these productivity gains, and about the long run growth of GDP and profits, has fuelled the recent increase in market volatility. In addition, there have been more immediate worries about the impact of a cyclical downturn in productivity and earnings.

Another area for debate has been the implications of any reversal in capital flows. As I have noted, buoyant earnings expectations drove up equity prices and encouraged high rates of investment. But alongside the rapid rise in the market value of US household wealth in relation to income came a sharp fall in domestic savings. The gap between savings and investment - manifested in an external current account deficit which has risen to an unprecedented rate of 4½% of GDP - has been filled by large capital inflows. One of the major questions in the current environment is whether foreign investors will continue to finance the current account deficit given the current uncertainties about the conjuncture. If not, there will be important consequences for the US and world economies.

A powerful lesson from recent problems in Japan and East Asia has been the debilitating impact of weak balance sheet structures. The need by both borrowers and lenders to put overstretched balance sheets on a sustainable footing reduces the potential of expansionary monetary policy to restore investor confidence and so can lead to a deeper and more prolonged downturn in domestic demand and economic activity. The issue in that case for the rest of the world would be where an increase in domestic demand in their own countries would come from to fill the gap left by the weaker domestic demand in the US.

So it should come as no surprise that, in the latest issue of the Bank of England's Financial Stability Review published in December, the strength of the dollar over the last few years, the size of the US current account deficit and its counterpart in the personal and corporate sector deficits were identified as amongst the most significant issues in the global conjuncture. A reversal of foreign inflows, leading to a correction in both the dollar and US domestic asset prices, would have an impact far wider than the US.

The fact that the US has enjoyed an unparalleled period of strong and continuous growth during the nineties owes a great deal, of course, to the policies of the US authorities. They have had to steer a difficult path between maintaining conditions conducive to growth while not being seen to underwrite the risks of "irrational exuberance" in security markets or lax lending standards by banks. This balance became especially difficult to strike towards the end of last year in the face of sharply lower corporate earnings projections and widening spreads on higher risk borrowings. As some lower-rated companies found access to the capital markets increasingly difficult, and as banks tightened credit standards, liquidity fears for some borrowers intensified. These factors, together with a sharp downturn in business optimism and mixed economic data, added to growing fears of a recession this year.

Such a climate of uncertainty calls for clear signals from the authorities and over the past two months the Fed has responded in a decisive fashion. The adjustment in the policy bias and recent cut in rates have increased the probability of a soft landing and will, from an international perspective, reduce the risk of a sharp reversal of capital flows into US markets. The combination of a slower growing - but still expanding - US economy and a weaker dollar should provide a more sustainable pattern of current accounts and capital flows, reducing the risk of instability in financial markets in both the US and abroad.

The direction of some of the trends we have seen in the last few weeks is not unwelcome, in particular the stronger euro and weaker dollar, and the reduction in oil prices; and a soft landing looks more likely as a result. But the speed of the adjustment remains a cause for concern. It is important that the irrational exuberance that marked the run-up in equity prices to their peak last year should not give way to irrational despondency. The view among central bank governors meeting recently in Basel was that while the next few months may be difficult, for the year as a whole the US economy will continue to grow, by perhaps 2-3%, and the overall world economy - helped by steady growth in the euro area - would grow again this year above its long-term average. No doubt this is a slowdown compared to recent rates of growth and a downward revision of earlier expectations of growth for the year, but it is not a downturn in the sense of contracting activity. A soft landing in the US with the associated benefits for the global economy still therefore seems to me the most likely outcome.

Implications for the UK

Turning to the UK, the need to avoid irrational despondency is even more apparent. While a slowdown in the US will have some impact on the UK, the direct trade affect will be relatively small. The UK is more dependent on growth prospects in the euro area, which is the market for more than two thirds of UK exports. If there is an impact, it is more likely to come via some other effect such as financial contagion or financial constraints on the UK affiliates of US companies. There is no doubt that a sharp correction in US equity prices would be felt in the UK but with a US soft landing the effects should be more limited, confined perhaps to some reduction in income from US direct investment or slower growth in financial and business services.

After all, the two economies are in different positions. The reasons the Fed gave to explain their recent cut do not apply to the UK. The Fed pointed to further weakening of sales and production; tight conditions in some segments of financial markets given lower consumer confidence; and higher energy prices. Current conditions in the UK are more robust. Consumer confidence measures were, if anything, higher in the fourth quarter than the third; household demand has remained relatively strong; consumer credit numbers are strong; and in the pipeline are planned increases in government expenditure, though the outlook for the public finances remains strong. However it is clear that the balance of risks has changed in the last couple of months, with the recent slowdown in world demand, signs of an easier labour market and the latest inflation numbers comfortably below target. All this will make the next meeting of the MPC interesting, particularly since the February meeting will include our quarterly review of the two year MPC Inflation Forecast, in which we will try to calibrate the effects of the various changes I have mentioned.

Proposed Revisions to the Basel Accord

Compared to the last US recession in the early 1990s, a source of strength to the global financial system as the US economy slows is the much stronger capital position of most major international banks.

The 1988 Basel Accord and its market risk amendment were intended both to set a floor to the capitalisation of the world's major banks, and to smooth out competitive inequalities between banks from different countries. Bank capital ratios have increased significantly in the last decade. Between 1988 and the end of the 1990s, the ratio of capital to risk-adjusted assets of major banks in the G-10 rose on average by around 3 percentage points. Of course, introduction of the Accord was not the only factor involved but studies agree it played a significant role in rising bank capital.

However, by the second half of the 1990s, it became apparent that the Accord required a radical overhaul to take account of changes in the nature of banking business and risk management since 1988. One concern has been that in some countries, various forms of regulatory arbitrage have diluted the level of capital relative to the true risks being run by banks

Last week, the Basel Committee, chaired by Bill McDonough, President of the New York Fed, unveiled its 'Second Consultative Package' which sets out the details of a new Accord. The intention is that this should be agreed by around the turn of the year, in order to allow implementation by 2004.

We warmly welcome the new proposals and have played a major part in their negotiation alongside the UK Financial Services Authority and other G10 central banks and regulators. We particularly support the proposed use of banks internal ratings to calculate capital. Banks should know more about the riskiness of their individual borrowers than, for example, external rating agencies or supervisors and the new Accord will provide them with the proper incentive to do so.

The new Accord also recognises that in today's complex banking markets, a focus on capital adequacy alone is not enough. This has to be reinforced by a rigorous review of banks' internal risk management processes, and also by greater transparency and market discipline. Together, these three mechanisms - which are intended to be mutually reinforcing - are known as the three 'Pillars' of the New Accord.

A fundamental change within the first Pillar - capital levels - compared to the original Accord is that improved risk management in banks has allowed the proposed new Accord to incorporate greater sensitivity of credit risk capital charges. There will be a menu of approaches, depending on the sophistication of the bank. A 'standard' approach differentiates between credit exposures on the basis of external ratings. A 'foundation' internal ratings based approach will allow banks to differentiate between credit exposures on the basis of their internal estimates of borrower default probabilities; and an 'advanced' approach allows other inputs required to assess credit risk also to be provided by the bank, rather than the regulator. In addition to all this, there will be for the first time an explicit capital charge for operational risk.

Systemic Implications of the Revised Accord

What I have described so far is how the Accord is intended to be applied to individual banks. But given the Bank of England's responsibilities for the stability of the financial system as a whole, our principal concern is with the overall impact on the system.

The Basel Committee has said that the new Accord is intended broadly to deliver the same level of bank capital on average across banks as at present. How should we assess the adequacy of this from the viewpoint of overall financial stability?

As I suggested earlier, the role of bank capital is to provide a buffer sufficient to cover unexpected losses. So it seems sensible to link minimum capital requirements to a confidence level. In its work, the Basel Committee's approach has been to set those requirements equivalent to an investment grade rating.

It is important that this rating level is maintained. First there is growing evidence that without it a large bank would have insufficient freedom of operation as their counterparties' limits on unsecured exposures stemming from interbank, swap and FX transactions to the bank concerned would be too small. Second, the frequency of banking crises does not suggest that the current minimum level of regulatory capital is too high: four out of the G-10 countries have suffered a banking crisis over the last decade.

Another important issue is the possible impact of any new capital requirements on the business cycle. It has been argued that capital requirements can potentially contribute to a credit crunch because in a period of severe downturn, they can become binding should write-offs and loan loss reserves reduce the amount of capital which a bank has available to back new lending. If banks are insufficiently forward-looking in their assessments of risk, more risk-sensitive capital requirements could lead to an added pro-cyclical effect to the extent that capital requirements would increase in recessions as the average riskiness of borrowers rose. It is therefore essential that banks take a longer term view of creditworthiness.

We think, however, that such fears of procyclicality are exaggerated and are more than matched by the other benefits from the new regime - in particular, the reduced opportunities for regulatory arbitrage and the incentives given to banks to strengthen their risk management.

Moreover, a number of factors seem likely to mute the impact of the new proposals on the cycle. First, many banks have a buffer of capital well above the regulatory minimum. Second, in a recession, demand for bank credit may anyway fall. Third, to the extent that banks (and ratings agencies) assign assets to risk categories in a forward looking manner, it should be possible to avoid wholesale reclassifications to lower credit-risk categories during cyclical downturns, particularly those of normal amplitude.

Conclusion

The new Accord will make a significant contribution to strengthening the international system. But even under the current Accord, banks should find themselves better placed than in the past to deal with any sudden downturn. A soft landing for the US still seems the most likely outcome but the system is in far better shape now than a decade ago to absorb, if necessary, a somewhat harder bump. I am not complacent and you can rely on the Bank of England to remain vigilant, whatever the outcome.