William J McDonough: Bank supervision and credit standards under Basel II – perspectives for SMEs

Remarks by Mr William J McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York and Chairman of the Basel Committee on Banking Supervision, at the Gürzenich Köln, Cologne, Germany, 25 April 2002.

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Introduction

Graf von Hohenthal, Herr Dr. Breuer, members of the panel, "meine Damen und Herren…"

It is an honor to join your discussion on the efforts of the Basel Committee on Banking Supervision to ensure that the international rules on capital adequacy serve the needs of twenty-first century banking effectively.

What makes this a special privilege for me is the opportunity to meet so many entrepreneurs, owners of small and medium-sized businesses, and others who make up the real engines of the economy. Your interest in the work of the Basel Committee reminds us all that we must look beyond the banking sector to ensure that the foundation we lay provides for the stability and growth of the entire economy. I have long emphasized that the role of supervisors is not to hinder growth or profit, but rather to promote the responsible pursuit of opportunity and innovation. As we improve the rules for bank capital, we must certainly keep this mandate in mind and consider the effects that changes to those rules may have on the economy.

Like you, I recognize the need for small and medium-sized enterprises to retain access to credit at reasonable and fair prices. Access to credit matters not just because credit can enable small businesses to grow, but more because small businesses enable the whole economy to grow. This is true not just for the "Mittelstand" in Germany, but also of entrepreneurial ventures around the world. In the United States, for example, small businesses traditionally create the majority of new jobs, invent a large proportion of all new technologies, and are responsible for nearly 40% of our gross national product.

Preview

I know that you are deeply interested in the steps that the Basel Committee is taking to ensure that small businesses continue to enjoy fair and open access to credit, and I am pleased to share with you the good progress that the Committee has achieved since the release of the Second Consultative Paper in January 2001. I'll begin with an overview of the importance of regulatory capital to the stability of the banking systems – and that of the economy – and how the Committee's current efforts will reinforce that stability. Second, I'll discuss some changes that are of particular interest to banks that lend to smaller businesses and to owners of small and medium-sized enterprises as well. I would like to close by giving you some insight into the process and the timeframe that is guiding our work to complete the impact studies and to move toward release of the final Consultative Paper. At that point, I look forward to hearing and learning from you in what I hope will be a rich discussion session.

Purpose of regulatory capital

First, let's look back for a moment to understand the path we've taken. The Basel Committee has long sought ways to ensure that banks hold sufficient capital relative to the risks they face. Capital, of course, helps individual banks to weather unexpected losses. On a macro scale, requiring all banks to maintain adequate levels of capital helps to safeguard the stability of the financial system. When a financial system is more stable, banks are better able to provide businesses and consumers with funding and credit through good times and bad, which promotes the long-term growth of the economy.

The risks involved in lending and borrowing have long been recognized, "For [a] loan oft loses both itself and friend," warned Shakespeare some centuries ago. For their part, banks – like all companies

– seek a healthy balance between risk and opportunity. Because banks serve as key intermediaries of credit within the economy, poor credit decisions harm not just banks, but borrowers as well. Overly restrictive terms for credit make loans less accessible to all businesses, impeding their ability – and that of the economy – to grow. If the terms for credit are too lax, loans may be extended in volumes that borrowers ultimately may be unable to repay in full. In such circumstances, both borrowers and lenders may experience losses and bankruptcies, depleting the future supply of credit. A banking system that encourages lending to companies or individuals in excess of their ability to repay is one that hurts not just borrowers, but society as a whole.

Goal of the New Accord

In promoting the efficient use of banks' capital resources, the member countries of the Basel Committee are revising a now outdated international agreement on the minimum level of capital banks are required to hold. That original 1988 agreement was relatively uncomplicated and represented an important first step in the development of an internationally acceptable standard. It has since been overtaken by advances in the financial sector – and in the economy. New technology, the globalization of financial markets, and innovative financial products and services have changed the way that banks measure and manage credit, market, and operational risks in a manner that the 1988 Accord could not anticipate. Let me be clear about this: the 1988 Accord is broken. It no longer meets the needs of sophisticated, twenty-first century markets. The new Accord will do just that.

Our goal for revising the Accord is to go beyond a rules-based structure and instead encourage banks themselves to identify, measure, and manage their risks appropriately. In particular, banks making use of the most sophisticated approach in the new Accord will increasingly be able to rely on their own internal ratings of credit exposures when determining how much capital to hold. A key part of this work is to provide banks with the appropriate incentives to improve constantly their processes for measuring and managing risk. In doing so, I believe that we are able to reinforce the stability of markets. In this regard, I am reminded of Goethe's view when he asked, "What government is the best? That which teaches us to govern ourselves." In a similar manner, I believe that the new Accord will motivate banks to enhance their understanding of the risks they face and seek better ways to manage them.

Because the changes proposed are far reaching, the Basel Committee is working collaboratively and publicly with supervisors, banks, and others involved in the financial sector. We've released thousands of pages of proposals and studies for public review and comment. The weight of those volumes demonstrates how hard we've been working and how complex the challenge has been. We are meeting with industry participants and others in a variety of formal and informal settings, such as this gathering tonight, to exchange views on the proposals. My colleagues and I have been enormously appreciative of the comments and questions that we've received and are very impressed with the quality of those views. Our proposals have been strengthened and improved by the public consultation process.

Based on the comments we've received, I believe that the industry very much shares our goal of aligning regulatory capital more closely to risk. Other market participants are likewise supportive of our efforts to develop an Accord that remains robust, relevant, and responsive to the demands and innovations of modern banking. Work on the proposal is continuing, and the Committee is currently addressing several important issues, including how the revised Accord may affect loans made to small and medium-sized enterprises.

Changes since the Second Consultative Paper

In countries around the world, and especially in Germany, much has been written about the effects the new Accord may have on the cost of credit for small businesses. I believe that, over the past year, we've made substantial progress in finding solutions that should alleviate those concerns for small business owners, regardless of whether they run a small high-tech consulting firm or a "BMW" ("Bäcker, Metzger und Winzer")-firm. I'd like to focus on changes to the internal ratings-based ("IRB") proposals that are relevant to small and medium-sized businesses. Changes concerning the treatment of loans to small and medium-sized enterprises include (a) modifications to the capital requirements so that they better reflect the underlying risk; (b) greater recognition of collateral provided by small and medium-sized enterprises; and (c) an adjustment to the capital charges based on a borrowing firm's size. I will also discuss proposals related to banks' equity – or venture capital – investments in other firms.

Modified capital requirements

Let me begin by explaining what we are doing to ensure that the capital held against loans made to small and medium-sized companies is truly reflective of risk. The Committee has on two occasions over the past year asked banks to assess the impact of the revised Accord. The data gathered have enabled us to evaluate the level of capital that our proposals would generate and to consider several modifications.

As you may know, our early findings suggested that the internal ratings-based approach as outlined in the Second Consultative Paper would have required banks to set aside too much capital. Contrary to the Committee's clear intent, banks would not have received a capital incentive for adopting this more sophisticated approach to capital adequacy. As a result, we had to adjust the capital requirements to provide banks with the right incentives under the new framework.

The Committee's aim is to avoid unintended consequences stemming from the new proposals. That's why we are taking additional time to make sure our proposals are right. To this end, we published in November a change in the IRB formulas for calculating bank capital requirements. This change – based on the Committee's internal research as well as additional input by bank risk management experts – reduces the extent to which capital will vary with the internal ratings banks assign to their exposures. One consequence of this important change is a reduction of around one-third in the capital charges on loans to many small and medium-sized businesses, relative to what the Committee had proposed in January 2001.

Greater recognition of collateral

A second change, announced in November, is to expand the range of acceptable collateral to let banks that qualify for the internal-ratings based approach recognize physical collateral and trade receivables as a way of reducing their capital requirements. The Committee is aware that small and medium-sized enterprises, such as the "Einzelkaufleute" and "GmbH," tend to pledge these forms of non-financial collateral when they apply for credit. By treating collateral in this way, the Committee estimates that IRB capital requirements on loans to smaller companies may fall by another 10 percent relative to the first change I mentioned.

We face a challenge in determining which forms of collateral or trade receivables offer the greatest level of protection to banks compared to other forms. This is not an easy task because each type of collateral has a unique historical record in reducing loss, records that also vary according to country. Moreover, banks in different countries manage collateral and trade receivables in very different manners.

Because of these differences, we believe that national supervisors are best suited to determine which sorts of collateral to accept in their respective markets. Rather than having the Basel Committee draw up a comprehensive list of permissible instruments, we are developing a set of minimum criteria for national supervisors to implement. I believe, particularly in the case of physical collateral, that banks using the internal ratings-based approach must obtain a timely, third-party view of the collateral's value. One test, for example, is that should the need arise, the bank must be able to dispose of it with relative ease. As a former commercial banker, I cannot see how any responsible banker would be able to sleep at night if these conditions are not met. On the other hand, it seems clear to me that if these conditions are satisfied, then the collateral does offer a bank protection against loss and banks will need to hold less capital against those loans.

Let me try to anticipate an immediate question you may have. What do we expect will be the net effect of the changes I have discussed? I believe that the impact of more risk-sensitive proposals will be very positive for small and medium-sized businesses in many countries. I understand that Jochen Sanio, the very capable President of the BAKred and, as of the first of May, President of the newly established FSA, expressed a similar view at a recent parliamentary hearing. He pointed out that based on our current proposals, on average, German banks' exposures to small and medium companies would require less than the 8% capital currently needed under the 1988 Accord.

But the issue is not simply a question of impact. The principal motivation behind the Basel Committee's efforts has been for bank capital requirements to take appropriate account of risk. In this regard, the Committee has over the last six months been engaged in a significant research program to assess whether the size of a borrowing firm should be explicitly considered when banks calculate their capital requirements.

At this point, the Basel Committee is discussing whether and how to factor a firm's size into the new framework. A lower capital charge for a portfolio consisting mainly of loans to many small companies makes economic sense because that portfolio is likely to be better diversified than one concentrated in loans to a handful of large companies.

Assuming the discussions within the Basel Committee continue to proceed in this direction, it means that loans to small and medium-sized borrowers would have lower capital requirements than loans to larger companies that are otherwise rated the same.

One point should be made about the treatment of loans to small and medium-sized enterprises. The Basel Committee wishes to ensure that our new framework reflects the sound risk management practices of banks. For example, many banks manage and evaluate their loans to smaller businesses in a way that is similar to the way they handle consumer loans. The design of the internal ratings-based framework will, therefore, allow a number of such loans to be treated like retail credits, as opposed to corporate loans.

This principle also will apply to another important issue within our capital framework, namely the role of a loan's remaining maturity. The Committee is sensitive to the concerns raised about the need to respect the long-term lending culture prevalent in a number of countries. In this context, we will examine carefully how, or even whether, maturity factors should apply to lending to smaller businesses.

Treatment of equity exposures

The changes I have referred to concern bank loans, which, of course, are a key source of funding for many companies. Nearly all businesses – especially those growing into medium or large-sized firms – also rely on investments from outside parties to build up their capital base. Here, I'm referring to outsiders who provide "venture capital" for growing firms, as well as to investors who buy the publicly traded stock of more established firms.

What do I mean by venture capital? Many small firms seek an "angel" investor, one who sees the potential in the firm's strategy and is confident enough of its success to make a substantial investment. The angel might be a single wealthy individual, an investment fund or, in some cases, even a bank. In exchange for the investment, the investor receives an ownership interest in the income and assets of that firm.

The Basel Committee recognizes that both venture capital and equity investments often are catalysts for innovation and growth in the economy. At the same time, we recognize that such investments can represent high-risk activities for banks. Consequently, the new rules are being designed to recognize the underlying risk while not discouraging or penalizing banks that wish to remain involved in venture capital and equity investing.

Our goal is to create a capital approach to equity exposures that builds upon sound internal bank practice and remains flexible enough to apply in any country. Our challenge is to develop a treatment that makes sense today and that will be responsive to the evolution of banks' practices in equity funding.

An equally important consideration is implementation, given significant differences in the nature of banks' equity holdings across countries and in the ways in which capital markets have evolved over time in each country. The Committee wants to avoid disrupting equity holdings that have developed under existing capital regulations --- whether these are long-term holdings, such as in Germany, or those associated with small business investment corporations in the United States. To this end, only new equity investments would be captured under the internal ratings-based approach for the first ten years after the date that the new Accord is implemented.

This is an area where the Committee has tried to navigate differences between national practices. We see the best way forward as offering two approaches to calculating regulatory capital for banks' equity exposures, one based on measures of market risk and a second based on the treatment of corporate loans. In either case, we intend for both methods to result in comparable capital requirements, which we will seek to confirm through our next impact study. Responsibility would lie with the national supervisor to determine the approach most suitable for its banks.

We expect that the new capital treatment will provide much better support for the healthy growth of equity financing and venture capital markets than the current Accord.

Summary of changes and need for standards

These important changes – modifying the capital charges, permitting greater recognition of collateral and trade receivables, and increasing the flexibility of the treatment of equity – should go a long way toward ensuring that banks that lend to small and medium-sized businesses are not disadvantaged under the internal ratings-based approach of the new Accord. I'd like to take a moment to speak more broadly about the internal ratings-based approach.

I think it is a significant and innovative step for banks' internal ratings to play a major role in their capital requirements – a step that plays very strongly into our goal of better aligning capital requirements and risks. To do this effectively, we need to ensure that a bank's internal rating system enjoys an appropriate degree of credibility and consistency when used in determining regulatory capital. Accordingly, we are striving to develop a meaningful set of minimum standards.

While I have focused on the first "pillar" of the new Accord, namely the minimum capital requirements, it's important to remember that there are two other pillars vital to the new framework: supervisory review and market discipline. I would be happy to talk about them during the discussion if you would like to hear more.

Timing of the New Accord

Let me close by telling you where we are in the process. To make sure that we get the new Accord right, members of the Committee and I felt it was important to continue to solicit and evaluate feedback from the industry in a variety of ways. Empirical exercises (or the quantitative impact studies as they are called) will be an important part of this dialogue, both those underway now and the more comprehensive study that will be undertaken in October.

The exercise we are designing for the autumn will provide banks with the opportunity to assess the impact of a fully specified proposal. It will be targeted to a wide set of banks worldwide, after which, the Committee will release its proposal for a third and final round of formal consultation. We expect the consultation will be relatively brief given all of the discussion and assessment that has taken place.

Let me stop here. I would be delighted to answer your questions.