Nout Wellink: Recent market turmoil – implications for supervisors and risk managers

Remarks by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the GARP 2008 9th Annual Risk Management Convention & Exhibition, New York, 27 February 2008.

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Introduction

I am pleased to join you today to speak about the recent financial market turmoil and the concrete responses of the Basel Committee. The mission of the Basel Committee is to improve the quality of banking supervision worldwide and to promote strong risk management practices at banks. This morning I would like to discuss some of our recent initiatives with you.

Issues and lessons for risk managers and bank supervisors

Let me begin by first focusing on some of the key issues that were identified during this recent turmoil and the lessons – in some cases painful ones – experienced by risk managers and supervisors. Quite frankly, some of the lessons learnt from the turmoil point to the importance of risk management fundamentals. While the triggers and transmission of risk always take on new faces, it is the basics that remain the same – complex structured products provide a stark example of this.

From the perspective of bank supervisors, I believe there were three fundamental shortcomings that contributed to and amplified the turmoil. These fundamentals can be found in all parts of the credit intermediation process. The first of these relates to the origination of credits. Here, the industry failed to consistently employ sound underwriting standards. In many cases, firms also neglected to define prudent firm-wide risk limits on these exposures. Second, risk management and measurement capabilities did not keep pace with rapid financial innovation and the evolution to market-based credit intermediation. Third, certain aspects of regulation, supervision and market transparency failed to reflect financial market developments and therefore contributed to weak practices at banks. These are areas where future practical improvements must be made.

Underwriting standards

As you know, the trigger for the turbulence was subprime mortgage lending, much of which took place outside the regulated banking sector. A large part of this lending was based on weak underwriting standards. Weak underwriting has long been the bane of banks and banking systems; the difference in this case was the rapid and global transmission of risk through the use of securitisation. Problems at banks are all too often caused by the failure to adhere to basic risk management principles, especially when new products and markets come into play. In many cases, this is due to the pressures that firms face to increase market share, combined with unrealistic expectations about growth and performance prospects. But no matter how much risk exposures get sliced, diced and distributed among financial market participants, financial innovation cannot mask poor underwriting. At the same time, the additional complexity, opacity and leverage resulting from certain structured products and off-balance sheet vehicles further magnified the problem, as it has not been sufficiently clear where the ultimate risk lies. This brings me to my second point.

Risk management infrastructure and financial innovation

Indeed, the second fundamental shortcoming is the wide disparity between the rapid pace of financial innovation and the risk management infrastructure on which this innovation was built. When I spoke at last year's GARP conference, I noted that the linkages between the various segments of the credit markets and financial institutions had been fundamentally altered. This is mainly due to increased market-based credit intermediation, or the originate-to-distribute model.

Historic or statistical measures of risk and exposure, such as value-at-risk, past loss experiences and name concentration in the traditional banking book have proved inadequate when assessing relationships in the originate-to-distribute model and how they may perform under stress. In fact, the use of these and other historic measures resulted in a massive understatement of stressed losses, which were far below the actual losses experienced to date.

As I suggested at last year's conference, the greater reliance on securitisation and other risk transfer mechanisms means that banks are more vulnerable to exposures building up or returning to the balance sheet when market liquidity seizes up. In addition, increased reliance on market liquidity means that problems in financial markets can adversely – and very quickly – affect banks' funding liquidity. However, for those institutions that stress test funding capabilities, many only assumed a firm-specific event.

The problems arising from poor underwriting were compounded by failures to manage firm-wide concentrations. Many firms were unaware of their overall exposure to subprime mortgages and related structured products, such as CDOs, whose repayment depend on such mortgages. These concentrations went far beyond traditional loan portfolio exposures and included CDOs and mortgage-backed securities held in the trading book; liquidity facilities extended to conduits; reputational exposures to sponsored SIVs; and counterparty exposures to the monoline sector. In addition to failing to understand their firm-wide concentrations, many institutions could not readily nor easily aggregate their subprime exposure sector when the crisis arose. This points to the need for greater investment in firm wide risk management and measurement capabilities.

Sound regulation, supervision and transparency

Finally, there were shortcomings in regulation, supervision and market transparency. It is important to point out that this crisis has played out under Basel I, which was instrumental in raising the level of bank capital in the late 1980s and through the 90s. However, the framework became outdated and could not adequately capture the types of risks that banks face in today's increasingly market-based credit intermediation environment. As a result, off-balance sheet exposures as well as operational, legal and reputational risks were not appropriately identified and measured. Moreover, liquidity supervision and regulation have failed to keep up with banks' changing risk profiles and growing vulnerability to market-based shocks. All in all, these issues underscore the need for Basel II and the necessity to continuously improve the framework.

Recent difficulties also highlighted the lack of transparency due to insufficient disclosure. CDOs of asset-backed securities are a particularly striking example. I must add, however, the turmoil also made clear that investors did not make full use of available information and placed excessive reliance on external ratings. Taken together, these factors resulted in banks and investors assuming excessive risk and concentration to the subprime sector – either directly or indirectly through structured products based on subprime mortgages.

Work programme of the Basel Committee

From the Basel Committee's perspective, the previous analysis points to a number of concrete measures that banks and supervisors must take. These measures should improve firms' resilience to market-based shocks and help strengthen confidence in core financial institutions. I will address three of these initiatives the Committee is working to complete, which are:

1) implementation of and further improvements to Basel II;

2) enhancing global standards for liquidity risk management and supervision; and

3) strengthening other risk management practices, particularly with respect to stress testing and valuations.

1) Basel II

Let me now say a few words about each of these initiatives, and I will start by underscoring the importance of Basel II. In developing the Framework, the Committee sought to provide better incentives for banks to capture exposures to structured credit activities, both on- and off-balance sheet, including ABCP conduits. The three pillars of the framework were designed to better reflect banks' evolving risk profiles, while building in cushions for uncertainty and forward looking risks. The implementation of the Basel II framework hence remains a high priority.

At the same time however, we have identified some areas within the improved Basel II framework that need to be strengthened to reflect the lessons of recent events. These relate to the Pillar 1 capital treatment of certain securitisations of complex products where the vast majority of losses in the banking sector have occurred. In Pillar 2 of the framework, we need to make sure that banks perform adequate stress tests and hold capital for uncertainties related to exposures coming back to the balance sheet for legal, reputational or liquidity reasons. And we need to build on the Pillar 3 disclosure requirements of the framework to strengthen banks' transparency around exposures to structured credit products and securitised assets, including banks' involvement as sponsors.

I also want to emphasise the importance of strong capital supporting trading book exposures. For the largest global banks, balance sheet assets have more than doubled between 2000 and 2006. Much of this growth relates to trading assets. Indeed, the vast majority of bank losses have been on retained trading exposures, particularly highly rated CDOs and leveraged lending. As supervisors, we need to make sure that the capital underpinning the trading book is commensurate with the risks that firms face. We therefore are supplementing the current VAR-based framework with a capital charge for credit default risk in the trading book. Moreover, to address the shortcomings of VAR, it is critical that banks have rigorous stress testing and scenario analysis that translate into prudent risk taking and limits along with strong capital.

2) Liquidity risk

Our second initiative relates to liquidity risk management and liquidity risk supervision. It goes without saying that over the past months, national supervisors have been closely monitoring the liquidity situation of their banking sectors and individual banking institutions to ensure that they enhance their resiliency to stress. The Committee is engaged in a major effort to strengthen global standards for liquidity risk management and supervision. We have identified a range of common weaknesses in liquidity risk management, including stress testing, contingency funding plans, disclosure and the management of off-balance sheet exposures. We are working to translate these lessons into robust global standards for risk management and supervision. Practically, this involves a fundamental review of the *Sound practices for managing liquidity in banking organisations*, which the Committee developed in

2000. We plan to issue the enhanced sound practices for public comment this summer. Issuing sound guidance and standards is only the first step; implementation and follow-up is the second. After the Committee issues the updated sound practices later this year, it will be incumbent upon banks to properly implement them and for supervisors to follow up to ensure proper implementation and adherence.

3) Strengthening other risk management practices

The third area to which the Basel Committee attaches high priority is the strengthening of other risk management practises. As I have indicated, there is a need to strengthen various aspects of firm-wide risk governance and management practices. Let me mention two specific areas, namely valuations and stress testing.

Valuation practices for complex trading assets have been a destabilising factor over the course of the crisis. When markets for financial instruments do not function properly, it is difficult to determine a fair value. Also, market participants have had a notable lack of confidence in firms' disclosure of exposures to structured products, processes for valuing positions, and the timely and accurate recognition of losses. This translated in a marked decline in financial firms' share prices. Recent financial disclosures are helping improve the situation but more needs to be done. With close cooperation from risk managers and other professionals, the Committee is carefully analysing how to help put valuation practices on a sounder long term footing. This is a topic the Committee is deeply concerned with, given the growing share of exposures that have been subject to mark-to-market valuations and which then flow through to earnings and capital. Disciplined fair valuation practices and clear sound practices can help make firms more resilient to stress. But poor practices can create major vulnerabilities for individual banks and for the financial system.

Furthermore, it also is critical that banks improve their firm wide stress testing practices. The turbulence has made clear that firms need to aggregate all exposures to a particular risk driver or related drivers and subject them to stress, also taking into account second round effects and the response of other market participants. This is particularly relevant since funding and market liquidity are increasingly linked. In addition, additional forward looking measures of risk must be applied when we see rapid growth in new products or markets, which have not been subject to an economic or financial market downturn. Firms must develop the governance and infrastructure to carry out rigorous stress tests that identify where the major vulnerabilities and firm-wide concentrations lie. And there needs to be a clear impact on risk taking and appetite. The Committee will be taking a close look at the lessons of the turmoil, how the current range of bank stress testing practices stacks up, and where we can strengthen the supervision around stress testing going forward.

Conclusion

In conclusion, the Basel Committee is focusing on practical and concrete efforts that will help strengthen risk management, regulation, supervision, market transparency for banking institutions. We have embarked on a focused and ambitious work agenda with clear deliverables. We also are contributing to the broader initiative of the Financial Stability Forum to address the issues resulting from the recent turmoil. Some of the Committee's efforts will take time, but having a clear road map should improve market confidence even in the shorter term.

The banking sector needs to have sufficient capital and liquidity buffers to absorb financial shocks and the uncertainties around how such shocks could play out in the future as the process of financial innovation continues. Risk managers need to continuously translate the basics of sound risk governance and management to rapidly changing environments. And importantly, regulators need to make sure that the infrastructure of supervision, regulation and transparency keeps pace with innovation and promotes appropriate incentives for sound risk management. There are no simple, quick fix measures that will prevent the next crisis. But I believe that the steps I have outlined will make the banking sector more resilient to the next set of shocks, whatever their source. Thank you.