Mr. Meister asks whether supervisory capital standards should be modernised or redesigned Luncheon speech by Mr. Edgar Meister, a member of the Board of the Deutsche Bundesbank, at the Conference entitled "Financial Services at the Crossroads: Capital Regulation in the 21st Century" orrganised by the Federal Reserve Bank of New York, in New York on 26-27/2/98.

I

I am delighted to have been given the opportunity of speaking to such a highly qualified audience at this major conference on capital regulation.

If you see a banker jump out of the window, jump after him - there is sure to be profit in it, said Voltaire, the 18th century French philosopher. Looking at the situation in South-East Asia, I am not entirely convinced that it would always be wise to follow Voltaire's advice. Even if all banks do the same thing, that does not necessarily mean that it is appropriate.

It is also becoming clear, however, that the Asian crisis has lent new points of emphasis to the already important topic of capital adequacy; in other words, risk and capital. In that respect, this conference has come at a very opportune moment.

What we have to consider is whether the concept of the capital accord, which dates from 1988, is still appropriate for meeting the challenges of the 21st century in terms of a good prudential supervisory standard? Or do we need an alternative system, and which alternative system of capital requirements might be superior to the present one?

There are divergences of opinion on this matter not only between the supervised institutions and the supervisors but also, in some cases, among the supervisors themselves.

In order to assess both courses of action (modernise or redesign), it would appear to be the obvious approach to use current, accepted criteria in the field of prudential supervision. These include:

The security level of the individual institution, i.e. its capacity and expertise in managing risk and its cushion of capital against losses. And closely linked to that: the overall stability of the banking system. I assume nobody wants a level of financial market stability that is lower than now.

as well as

The regulatory burden and level playing field aspects. Streamlining supervision and deregulation are important additional conditions for avoiding competitive disadvantages caused by banking regulation and for optimising the supervisory system on cost-effectiveness criteria. The regulatory burden cannot be the main deciding criterion, however. Furthermore, prudential measures should not themselves create competitive discrepancies between different groups of banks.

II

In terms of considerations of risk, an ideal capital standard should be designed to fully reflect an institution's risks and to derive a capital base which takes due account of risk. At the same time, it would be desirable if this standard raised market discipline. In reality, we are still too far away from that theoretical ideal.

There are differences in the measurability and hence also in the controllability of the main risks to which banks and other financial intermediaries are exposed. With the risk controlling techniques that have now been developed and on account of the availability of the input data, market risks, for example, can be measured quite accurately in most cases.

By contrast, in what is still the main risk area for banks, credit risk, a purely quantitative determination of risk - comparable to market-risk modelling - is much more difficult and has not yet been achieved. For that reason, assessment of the credit risk is still strongly marked by traditional methods, i.e. the judgement of the banks' credit officers.

As we have heard before, the efforts to improve the quantification of credit risks (by using models) are mainly hampered by the inadequate availability of data or their poor quality. For that reason, the recent survey on data sources by the ISDA to develop a reference and liquidity assessment for credit risk modelling is to be welcomed. It remains to be seen, however, whether the quality of the data in major market segments will be adequate.

Operational risks, too, including - for example - inadequate segregation of duties, fraud and errors in the field of data processing, are very difficult to model on account of the even greater problems concerning data. Measuring these risks is therefore rather a combination of estimate and guess; in other words, a „guestimate“ which is largely based on data not objectively observable.

III

The difficulties in risk measurement are a problem for the institutions, but also for prudential supervision for which it is difficult to define capital requirements.

Our existing regulatory framework aims, not least, to ensure that the institutions have an adequate cushion of capital as a protection against unavoidable losses. Although this "shield" of capital is supposed to cover all risk factors without them being broken down in greater detail (for operational and legal risks, too, for instance), the calculation of the required supervisory capital is essentially geared to **a single** risk factor: the default risk (and, to a lesser extent, the market risk, from January 1998 onwards).

Bankers and some supervisors have recently called the Capital Accord into question, not least because of its inexact categorisation of risks. It is pointed out that exposures to OECD countries are uniformly assigned a risk weighting of 0%, for instance, although there are considerable differences in terms of risk within that group of countries. The same applies to exposures to non-banks with a weighting of 100%, including blue chips that are known worldwide. Additionally, it is claimed that the degree of diversification in the loan book is not taken into account. This is said to result in a misallocation of funds since they are not used in the most productive way.

IV

This is the backdrop against which more sophisticated methods of credit risk measurement are discussed, ranging from a subtly differentiated prudential weighting scheme, the use of external or internal rating, the inclusion of portfolio effects and credit risk models to new concepts completely different from the Capital Accord. It is my assessment that the supervisors are fundamentally open-minded about these discussions. The new concepts include, in particular, the pre-commitment approach and more self-regulation, as proposed by the Group of Thirty.

Pre-commitment implies that a bank decides itself how much capital it will hold within a given period to cover the risks arising from its trading book. Sanctions will apply if the accumulated losses exceed that amount. This idea is tempting in many respects. It could make things easier for the supervisors and the regulatory burden would be lower for the institutions. Moreover this approach is highly market-oriented.

There are a number of fundamental difficulties, however. The pre-commitment approach involves a purely ex-post analysis of a bank's risk and capital situation. This perspective results in supervisory authorities reacting rather than specifying a given level of capital for the institution in a preventive manner. Without wishing to pre-empt this afternoon's discussion, I perceive the danger of an institution accepting additional risks if there is a threat of the pre-commitment being infringed and hence of regulatory sanctions. If there is a danger of the amount of capital being exceeded, some traders will attempt to change course abruptly in accordance with the dictum "If you are in trouble, double".

A key problem also consists in finding a consistent penalising mechanism. Assuming that the risks taken result in the institution suffering losses higher than the earmarked reserved capital, banking supervisors would have to impose penalties which would lead to the financial difficulties being even bigger.

Furthermore, the market is to be informed of this for the purpose of strengthening market discipline. It is, above all, this envisaged sanction - so it seems to me - which meets with considerable reservations on the part of many institutions and supervisory authorities. I am quite doubtful whether institutions would be prepared to go that far in terms of disclosure.

At the risk of exaggeration, and relating to the concept of the bank as a whole, the pre-commitment approach represents a bank's promise that it will not become insolvent. If that promise cannot be kept, it will remain an open question - at least in critical cases - whether the supervisors can or will impose sanctions.

A proposal by the G-30, which goes further than the pre-commitment approach, amounts to leaving supervision and the development of regulatory strategies basically to the market or to a small group of major international financial institutions. The involvement of supervised institutions in the development of regulatory standards is not new in principle. It has been tried and tested. Whenever certain methods have become state of the art, supervisors have always been ready to adopt such standards as binding - as was latterly the case for the recognition of internal models for market risks.

Nevertheless, there may be problems, for example, if there are no administrative sanctions to enforce the standards. How binding would they be? Trusting solely in an effective market control, pre-supposes a comparatively high degree of transparency. As in the case of the pre-commitment approach, it appears to be questionable whether all the market players would be prepared to disclose their risk positions and losses to the market, for example. That would simultaneously mean them revealing market expectations, trading strategies and other business secrets.

Furthermore, it would not be greatly surprising if the interests of this select group of institutions were not identical with the general interests of the financial industry. In particular, there is the possibility of competitive distortions at the expense of smaller institutions. As mentioned above, the possibility of supervisory standards, including voluntary self-regulatory standards in the private sector, causing new competitive problems should at all events be avoided.

V

As concepts, the pre-commitment approach and self-regulation as proposed by the G-30 can indeed supply important and thought-provoking ideas. Given the present prudential standard, the advantages of these alternative concepts consist, for example, in a reduction of the regulatory burden and banks having even greater freedom in their risk management by virtue of a pronounced market orientation.

At the same time - in addition to the reservations already mentioned - I perceive the danger of a decline in the overall security level of the individual credit institution and the banking system. Existing risks might be covered by less capital than hitherto under the Capital Accord.

Self-regulation aiming at greater market discipline would be welcome. The alternative concepts that have been referred to here would probably not be able to achieve that on a lasting basis or especially if a bank or a banking system were in a difficult situation, and would not be able to make up for the disadvantages of institutions having a lower capital base.

What should also be given consideration is that pre-commitment and self-regulation - as advocated by G-30 - is intended to apply mainly to large, internationally operating banks. These are precisely the players who have an especially prominent role in terms of the stability of the financial markets.

At the same time, we know that the world of risk has become more complex during the last few years and that the risks which the institutions have to bear under the pressure to perform have increased. Risky high-yield transactions in emerging markets, for example, are likely to become increasingly significant in future despite the recent turmoil in Asia.

Precisely the events in South-East Asia demonstrate how difficult it is to determine bank-specific risks with sufficient accuracy. Even leading rating agencies have tended to run behind the markets in line with the maxim: “Please follow me, I am right behind you.”

VI

Capital is therefore still a modern prudential requirement. The Basle Capital Accord is, in this context, a rough and comparatively simple approach.

This standard, which has now been put into practice virtually worldwide, undoubtedly has some weaknesses. It has however demonstrated its suitability under changing conditions in the almost ten years since its introduction. In my view, the empirical findings are definitely positive.

However, the Capital Accord has not worked where the calculated capital was not actually in place. I am referring to credit institutions in many countries which have experienced crises. In such cases, some institutions only **formally** fulfilled the norm of 8% minimum capital. Actually, an evaluation of assets and liabilities in line with market conditions would have shown that the capital had been used up long beforehand.

As the Capital Accord sets the capital requirements more conservatively than the alternative approaches mentioned, there remains a buffer for cushioning the risks which are difficult to measure - operational and legal risks, for instance. To that extent, an adequate cushion of capital can to a certain extent make up for shortcomings in risk identification, measurement and control.

VII

To come back to the original question: I am in favour of an evolutionary solution. The Basle Accord should be modernised and not - at present - be replaced by other concepts. There are indeed other approaches which are worth discussing, but at present I cannot identify any convincing alternative concept among them which would be operationally viable, practicable and superior to the Capital Accord.

The Capital Accord itself is adaptable enough for new developments in the markets to be integrated into its system in a meaningful manner - as occurred in the case of market risk, for example. This also applies to all currently impending topics for discussion, such as on-balance-sheet netting, credit derivatives, credit risk models and new capital elements.

In return, this also implies capital buffers becoming necessary for risks that have so far not been covered: given an easing of capital requirements in other areas, buffers for operational risks, for valuation risks and for concentration risks, for instance, must no longer be a “no-go” area.

Generally speaking, further qualitative requirements may also help to curb risks and hence have a stabilising impact in micro and macro-prudential terms. In that respect, the Basle Committee’s “Framework for the Evaluation of Internal Control Systems” is especially important. Quantitative and qualitative minimum standards for the use of credit risk models based on a widely used and convincing practice would also have to be specified in due course.

In my view, self-regulation can have a stimulating effect, but it cannot replace an administrative supervision of banks and other financial intermediaries. To that extent, self-regulation is an approach which complements prudential supervision. I believe that this assessment is reinforced by the various bank crises that have occurred in the past and has been borne out yet again by the Asian crisis.

A basic stance of this kind virtually necessitates supervisors working closely with the institutions. That is very helpful for finding regulations which are up-to-date and compatible with the market and, at the same time, strengthen market discipline and do not lose sight of the stability of the overall system.