Mr Clementi comments on the systemic aspects of the Basel proposals

Speech given by Mr David Clementi, Deputy Governor of the Bank of England, at a Financial Services Authority Conference, held in London on 2 December 1999.

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Ladies and Gentlemen,

I am delighted to be given this opportunity to address you today. I must first express my admiration for the pro-active and thorough way that the FSA is seeking views from the industry on these important proposals. I know that as well as this conference, their efforts have encompassed briefing sessions, circulars to banks, advisory group meetings, and a dedicated website. There will no doubt be a few focus groups springing up in due course! The Bank of England is in turn holding regular meetings with the main trade bodies, while various of the Basel Committees involved in developing the proposals have conducted surveys and received presentations from banks and others. I hope that, at the end of the process, if differences of opinion remain between the authorities and the banking industry, this will be the result of rational divergence between our different perspectives, and certainly not through any failure of communication.

I intend to direct my comments to the systemic aspects of the Basel proposals. The Bank has a close interest in this subject and I will start by outlining the relationship between the design of the regulatory system and the Bank's core purposes. In promoting the stability and efficiency of the financial system, we favour capital charges based on more sensitive risk measures. Some argue that such measures are procyclical and add to the vulnerability of the system as a whole. I will deal with this issue before going on to discuss some features of the new proposals. In particular I will consider the pros and cons of more complex rules, the use of internal ratings and the measurement of operational risks. I will end by looking beyond the current proposals at potential new chapters for the Basel Accord, including the harmonisation of provisioning policies and the development of capital charges for financial conglomerates.

The role of the Bank of England in financial stability

As many of you may know, the Bank of England has three core purposes: first, to maintain the integrity and value of the currency, generally referred to as our monetary policy objective; second, to maintain the stability of the financial system, both domestic and international; and third, to ensure the effectiveness of the UK's financial services. The Bank's monetary policy role is well known through the minutes of Monetary Policy Committee meetings and the quarterly publication of the Inflation Report. But a similar transparency is pursued in relation to financial stability with the publication semi-annually of the Financial Stability Review.

Our interest in the regulatory architecture most obviously stems from this second objective. Clearly regulation of financial market participants is not the only means of ensuring such stability: a stable macroeconomic environment, which is what our monetary policy objective is about, is a major factor in avoiding financial system dislocations, while the robustness of the market infrastructure, such as payment and settlement systems, is also crucial.

The design of the regulatory framework also has implications for the third objective, the effectiveness of UK financial services. There is a widespread view that greater stability can only be bought at the cost of reduced competition, meaning that these two objectives have to be weighed up against each other and trade-offs made. I would suggest an alternative point of view, which is that these two objectives are often fundamentally aligned. An *effective* financial system is one in which funds flow to the most productive projects, productivity being measured on the basis of long-term rewards and after an appropriate discount for risk. But this is also a *stable* financial system. Put another way, short-term stability of a sort *can* be bought through over-regulation or protectionism. But in the longer term, the likely result is an unprofitable industry focused on regulatory arbitrage rather than its prime business, with little instinct or incentive for assessing risks and rewards. It is noteworthy that there are numerous examples of financial systems in emerging markets which have exhibited both fragility and inefficiency.

At the Bank of England we do still consider that the stability of the financial system depends crucially on the stability of the banking system. Banks are at the heart of the payments system, they are the principal source of funds for many businesses, and they are an important savings medium for a large part of the population. The regulatory framework in turn affects the behaviour of banks, making it essential to get it right. It needs to create both the right incentives, and establish the right level of buffer - in the form of capital - to protect the system. We fully support the Basel Committee's objective of updating the 1988 Accord to make it more comprehensive and risk sensitive. And as a member of the Basel Committee, the Bank is working alongside the FSA to ensure that these objectives are delivered.

Importance of risk sensitive capital charges

I am aware that some commentators have questioned the aim of making the system reflect risk in a more differentiated way. One argument is that this will make capital charges procyclical, so that economic downturns or external shocks are amplified by the regulatory demand for higher capital. There is a concern that the consequences could be particularly severe in the case of lending to emerging markets, where rating changes have sometimes lagged the onset of crises.

This is certainly a risk, and one which we have to take seriously. Clearly there could be macroeconomic implications, both domestically and internationally, possibly on a systemic scale. We are not sure, however, that the answer lies in making the framework less sensitive to risk, perhaps by smoothing over bad news in some form, for example by ignoring or delaying recognition of rating changes. This would involve the same dangers that I recall from the days of hidden reserves in UK banks, when the knowledge that unwelcome events could be hidden from view led occasionally to a lack of rigorous risk assessment in business decisions. In fact, part of the underlying problem of procyclicality is that risks are not recognised early enough, in time to allow lenders to exert a more gradual and beneficial discipline on borrowers. The capital framework - and, equally important, bank provisioning policies - need therefore to be as forward looking and dynamic as possible. Since ratings - whether external or internal - are influential in provisioning and will in the future be influential in capital, they in turn have to be more forward looking. This is why in the sovereign context we place particular emphasis on the importance of countries adhering to international transparency standards. No rating can be reliable without adequate information on the economic and financial situation of the country. The Basel paper does of course propose that compliance with the IMF's Special Data Dissemination Standard is a pre-condition of a lower risk weight.

More generally, we have concluded that making the capital requirements more risk sensitive will help ensure that borrowers are charged a more appropriate price for their debt, and limit the build up of unsustainable volumes of debt. This seems to us a better system than the current, extremely risk-insensitive framework of risk weights, where in the sovereign context nothing short of a rescheduling results in any change in capital requirements for exposures to OECD sovereigns, while for non-OECD sovereigns the charges are completely invariant. It is worth noting here that a similar kind of argument applies in the context of public disclosure by banks, which is also one of the key planks of the proposed new Accord. There is a risk that in some circumstances there are drawbacks associated with this, since disclosure could make a troubled bank's position worse at a difficult moment. But overall, we think the likely behavioural changes induced by greater transparency offer more benefits than risks. By this I mean that the prospect of having to disclose more about positions to the market will reduce banks' willingness to take on highly risky positions in the first place.

Benefits and drawbacks of complexity

A number of other commentators have questioned the *effectiveness* of introducing greater complexity into the Basel rules, on the grounds that the framework will always be inadequate to cope with innovation and arbitrage. It is certainly clear that a minimum capital framework, however sophisticated, cannot on its own capture the full range of risks in a banking organisation. This has been recognised by the Basel Committee; it is the reason why the Consultative paper introduces the supervisory review process for individual banks under Pillar 2 of the framework, as a complement to the minimum capital standard laid down in Pillar 1. It is equally clear that supervisors, even armed with powers to review the individual capital adequacy of banks under Pillar 2, may under some circumstances be less effective than the market at disciplining risk taking, which again is why the Basel Committee is emphasising the importance of enhanced public disclosure under Pillar 3 of the Accord. But to my mind there is very considerable scope for improving the risk-sensitivity of the minimum capital standard before the benefits of this begin to be outweighed by the costs of greater complexity. Indeed, greater risk sensitivity ought in some respects to mean more *simplicity* in the capital framework, achieved by aligning capital with a common underlying concept of risk, such as internal or external ratings. Internal ratings indeed offer a very significant opportunity to bring regulatory measures of capital more into line with the economic measures established by industry best practice: in the absence of this, arbitrage of the system through securitisation and other means will remain a problem. The current review also offers the opportunity to iron out some of the existing, fairly arbitrary, quirks of the current Accord. For example, by identifying the common characteristics and residual risks underlying various types of credit risk mitigation techniques - collateral, guarantees, netting, and credit derivatives - it is hoped that a more uniform and consistent treatment can be applied to these instruments in place of the various, somewhat ad hoc, treatments that have grown up to date.

There is perhaps one caveat that should be attached to the aim of introducing greater risk sensitivity. This is that it often entails much greater reliance on the judgement and competence of the supervisors. This can be seen in the evolution of the Basel Accord to encompass banks' internal market risk models, if approved by supervisors, and in the new proposals to allow some banks' internal ratings to be used for credit risk capital. It is also evident in the emphasis on individual supervisory judgement in Pillar 2 of the consultative paper. We believe this is the right direction to follow in the case of G10 banks and supervisors. It is, however, more questionable whether such a system is easily exportable outside the G10, in particular to some emerging markets. Indeed, even amongst the G10, some supervisors (such as the US) are actively contemplating drawing a two or more tier distinction in the capital rules applied to banks, depending on the level of complexity of the organisation. I entirely agree with Howard Davies that it is essential that the Basel framework, if it is to remain a global standard, continues to encompass a menu of options which accommodate different needs.

I also do not wish to gloss over the fact that there are some very knotty areas in the proposals that have to be tackled before the Basel Committee can deliver on its objectives of greater risk sensitivity and comprehensiveness. The FSA is today going to tackle four of the most difficult, namely credit risk mitigation, operational risk, internal ratings, and interest rate risk in the banking book. I would like to take this opportunity to make a few observations on those areas that are of particular interest to us.

Use of internal credit ratings

The Bank has, as some of you may know, been devoting considerable thought to development of the internal ratings based approach to setting capital for credit risk. This is in part because we have been able to utilise the expertise we have built up in the course of our work on credit risk modelling, on which the Bank and the FSA held a joint conference last year. But more importantly, it is also because we consider this part of the Basel proposals to be of the utmost importance to achieving a balanced and stable framework. In particular, the availability of this approach is a very important safety valve for the market pressures and distortions that could otherwise arise from the use of external ratings. I mean no disrespect to the existing well-known rating agencies - indeed quite the contrary - when I say that the last thing the regulators would want to see is a mushrooming of untried rating agencies all clamouring for "recognition" from supervisors. We have no wish to see the supervisory net extended, by way of quasi-regulation, to rating agencies; nor do we wish to substitute regulatory judgements for the very satisfactory investor discipline that currently operates in the ratings arena.

I note that the EU Commission's consultative paper on reforming the EU framework goes further than the Basel Committee's and talks of designing an internal ratings based approach that could potentially be used by all banks, not just large sophisticated ones. This makes some sound sense, since, to my mind, banks should seriously question what value-added they are bringing to the credit intermediation process if they do not have a reasonably systematic mechanism for assessing and pricing borrower risk. There are indeed various ways that an internal ratings based approach could be designed, with varying degrees of sophistication depending for instance on the number of "buckets" that are used, whether maturity is incorporated as an additional dimension, and whether the bank's own internal estimates of loss-given-default are recognised, as well as simple default probability. We do not at this stage have a strong view as to where along this spectrum of complexity the internal ratings approach should be pitched. Several options need to be explored, including the possibility of offering a choice of approaches to supervisors, or an evolutionary framework whereby the system could develop in sophistication over time. In principle, we would certainly like to see a system that a reasonably large number of banks could sensibly aspire to. There are only two caveats that I would make. First, of course, there are the implications for supervisory resources if a very large population of banks have to have their internal ratings systems approved. And secondly, even a simple framework has to observe certain minimum requirements. This means the ability to relate an internal rating to a quantifiable concept, such as loss-given-default or default probability; the ability to demonstrate that this relationship is historically valid, or - in the likely absence of long runs of data - at least plausible; and third, as I said before, a forward-looking dimension to the rating. Whilst the Bank of England is doing its best - I hope with some success - to help the economy avoid the booms and busts of previous decades, banking is likely to remain a cyclical industry, and to my mind it would be simply imprudent to base ratings and capital on a borrower's position at the top of an economic cycle.

Operational risk

Use of internal ratings will of course raise many of the sorts of difficulties for testing and validation that were identified for credit risk modelling. However, we are at least talking about a reasonably well-defined type of risk and one which is quantifiable in statistical terms. We are in much more difficult territory when it comes to operational risk. The term operational risk covers a wide range of types and sources of risk, and banks' data bases of loss are generally patchy. There are numerous questions not only about the appropriate design of the charge, but also about the appropriate level. It is clear that some types of operational risk, such as fraud, can result in huge spikes of loss, as we saw in the case of Barings and Morgan Grenfell. Even though we are concerned with protecting the system, I feel it would be inappropriate to expect most banks to hold an additional cushion of capital to cover these sorts of very rare events: it would either be grossly excessive for most of the time, or alternatively seriously inadequate if a major problem arose. So the focus here must be on systems and controls, and on using variable target capital ratios under Pillar 2 to encourage improvements in these. Moreover, the appropriate level of capital will depend in part on how far we think operational losses are correlated with other types of loss which are already covered by capital. Probably there are some types of operational loss - processing errors, settlement delays - which do not exhibit a high correlation with either credit or market risk. But in practice, there is clear evidence that credit or market losses put pressure on the firm, which can push managers into fraud or result in operationally-risky cost cutting. There have certainly been occasions when operational losses have only been revealed because of a market downturn or similar event. As I heard it graphically expressed the other day: "It is only when the tide goes out that you discover who is not wearing a bathing costume"!

I am optimistic that, over time, operational risk will become more measurable and that, as was the case for market risk models, a consensus on methods of quantifying it will emerge. The Basel Committee's framework will certainly have to be flexible in the face of this evolution. However, we should also not lose sight of the fact that the Committee's announced aim is not just coverage of operational risks, but "other" risks more generally. Episodes of market turmoil over the past couple of years have demonstrated just how wide is the range of risks that are not currently explicitly covered by regulatory capital; I would include under this heading market liquidity risk, individual bank liquidity risk, correlation risk between credit and market risks, and legal and reputational risk. These types of risk can certainly produce systemic disruptions. My expectation would be that, even with further advances on measuring operational and credit risk, most banks will want to carry a chunk of fairly undefined capital to cover rainy day events.

Future challenges

Finally, before I close, I would also like to stress that many challenges will remain for the Basel Committee even after it has completed its current review of the Capital Accord. I have referred at various points to bank provisioning policies. This has traditionally been an area where internationally there has been little attempt at harmonisation (except at the level of very broad principles). But the systematic use of internal ratings by possibly quite a large part of the banking population will arm supervisors with valuable information about expected losses, and ought to focus attention on the adequacy of provisions to cover such losses. Indeed, more generally, the whole question of the appropriate accounting valuation framework for the banking book may have to be re-examined in the light of any recommendations that come from the Joint Working Group of accounting standard setters that is currently looking at accounting for financial instruments.

Also looking to the future, the issue of recognising full scale portfolio credit risk modelling will inevitably resurface. The resulting recognition of diversification effects could result in quite a large reduction of capital for well-diversified banks - who are also of course in many cases the largest, most systemically significant banks. At this point we will have to think very hard about what level of capital we really feel comfortable with in our systemic organisations, and in particular whether an individual firm's capital requirement ought to reflect the systemic externalities it poses.

And finally, with the rapid growth of banking sector M&A, and conglomerisation across businesses, there is undoubtedly more work to be done on the appropriate regulatory framework for mixed-activity firms.

In short, I believe there will be many future opportunities like today's, in which we invite the constructive input of industry participants.