Mr Hofmann gives a lecture on "Ratings and the emerging new equity standards: a symposium on the BIS proposals"

Lecture delivered by Mr Gerhard Hofmann, Head of Banking Supervision Department on behalf of Mr. Edgar Meister, member of the Directorate of the Deutsche Bundesbank, at the symposium arranged by the Center for Financial Studies and New York University, held in Frankfurt am Main on 2 December 1999.

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I

Ladies and Gentlemen,

The new Basel capital regulations in general, and the proposed prudential use of ratings in particular, are major milestones in the history of banking supervision. I am especially pleased to see that, besides the many banking supervisors and bankers who are taking an interest in the Basel discussion paper, academic economists are likewise joining in the debate on the new supervisory rules more vociferously than they did in the past. Hence today's gathering also helps to foster the dialogue between academics and practitioners.

II

A need to take action has arisen in the area of the Basle Capital Accord of 1988, since, on the one hand, the nature, scale and complexity of the transactions differ considerably from the conditions prevailing in the late eighties while, on the other hand, the available risk-management techniques have improved substantially in recent years. The old fixing of prudential capital by rather rough-and-ready methods has led in some cases to misallocations, and the incentive for big banks, in particular, to conserve capital (by means, say, of asset-backed securities transactions) has assumed greater significance. Credit derivatives and netting arrangements are likewise growing in importance.

Novel methods of measuring credit risk enable differences in credit-worthiness between individual borrowers to be quantified more accurately. As a result, the existing subjection of all enterprises to a uniform risk weighting of 100% is too generalised. The old risk weighting scheme is to be replaced by up-to-date methods, especially ratings, which permit a more sophisticated and more precise measurement of risk.

By these methods, the capital to be held for supervisory purposes will approximate more closely to what is known as the "economic capital", which every bank assesses for itself internally to cover credit risk.

At the same time, however, other risks – such as interest-rate risk on a bank's loan book and operational risk – have become a focus of interest. The objective of safeguarding the stability of the financial system can be duly taken into account only if such risks, which have hitherto been covered only indirectly, become subject to capital charges. Whether, and to what extent, a capital saving ultimately results for the banking industry as a whole cannot be said for certain in advance; the answer will differ anyway from one bank to another.

III

Ladies and gentlemen, in future capital alone will be able to ensure the stability of an individual bank and of the financial sector as a whole to a lesser extent than it could in the past. That is why the Basle Accord rests on three well-known pillars which stand side by side with equal status:

- The first pillar relates to the minimum capital requirements needed for covering credit risk, market risk and other risks.
- The second pillar, known as the "supervisory review process", comprises an enhanced qualitative examination of the individual risk profile of a bank.
- As the third pillar, supervision is to be supplemented by greater market transparency.

All three pillars serve in a sense (to remain in the same picture) to carry the roof, meaning to contribute to the stability of the global financial system, also in the future. Credit institutions and banking supervisors alike consider that there is a special need to preserve the "level playing field" and prevent distortions of competition.

IV

Competitive considerations, especially as between the United States, with its capital-market-oriented financial system, and Europe, with its banking-oriented financial system, play a major role, especially in the recognition of external ratings.

Thus, for enterprises that take advantage of the capital market, an external rating is normally an essential condition for informing bond buyers about a firm's credit standing. Under the credit-oriented universal banking system, by contrast, the bank, as an intermediary, must arrive at a credit appraisal of its own. The differences between banking systems are naturally also reflected in the number of external ratings of enterprises: some 8,000 external corporate ratings in the USA compare with only about 600 such ratings in Europe.

Even if, happily, three new private rating agencies have recently been established in Germany, it will be some years before they have compiled a significant number of corporate ratings. To prevent distortions of competition, it is therefore imperative that, as an alternative to recourse to external ratings, internal bank rating systems be used, which are inherently of equal value and come into force simultaneously.

In connection with the proposals on the external rating of countries, the question of the treatment of public authorities below the level of the central government also arises. In the German view, the status quo should be retained, that is to say, there should be no change to the present right to choose a supervisory authority for the risk weighting of Land and local governments. The zero-weighting of loans to Land and local governments would then still be possible. To my mind, it would not be fitting for every minor municipality to have a rating of its own, if only to have an appropriate risk appraisal in the future.

V

Quite apart from the competition argument, in the light of the above-described "rating gap" between the United States and Europe, there are a number of substantive criticisms that can be levelled at the prudential use of external ratings.

For instance, external ratings may prompt a bank to exercise less care in granting credit. That would be contrary to the avowed aim of supervisors of setting the supervisory framework in such a way that the banks themselves have every interest in improving their own risk-management techniques. In addition, it might be objected that rating agencies are being given too much power in the context of regulating banks, because they determine by their rating how high the capital requirements for banks should be.

Moreover, it is feared that strong competition among the agencies might lead to a watering-down of the results, or that enterprises requiring a rating might engage in a kind of "rating shopping". Finally, the Asian crisis is cited, in which, it is claimed, external ratings contributed to the herd instinct exhibited by the banks.

I share the view which is occasionally expressed that the banks' function of assessing risk by means of an examination of creditworthiness is in essence not "outsourceable", but that a risk examination of their own, and thus made on their own responsibility, prior to the granting of credit, is fundamentally indispensable.

As a result of the amendments being prepared in Basel and Brussels, I expect that internal rating systems for the computation of capital will in future play the crucial role in the banking systems of Europe. Besides that, however, external ratings in the field of capital-market transactions, e.g. in the case of asset-backed securities constructs or corporate financing through debt securities and the like, will likewise increase in significance.

VI

The authorisation of internal bank ratings – like that of external ratings – will be linked to qualitative and quantitative minimum standards. A working party of the Basle Committee is currently engaged in elaborating the framework of an "internal ratings-based approach" to the capital charges. The keystone of any capital computation is the probability of default exhibited by individual rating categories to which borrowers are assigned. The expected cost of default sustained by a bank results from that probability of default and the expected losses in the event of the insolvency of a borrower. Both variables (default probability and expected loss ratios) are to be related to the size of the credit granted, and should be included in the calculation of the interest charged on loans.

When the conditions for the internal rating system are fixed, the German representatives on the Basel Committee will see to it that the structures of our banking system are duly taken into account. In particular, the conditions in Basel and Brussels must not be set so restrictively that small and medium-sized institutions have no chance from the outset of clearing the hurdle erected in this area by the supervisory rules.

If internal ratings are recognised for a broad range of credit institutions, no drawbacks will arise with respect to an adequate and low-cost provision of credit for the business community. That goes above all for small and medium-sized businesses.

The proposal for an internal rating system recently put forward by the Federal Association of German Banks points in the right direction, namely at making internal bank rating systems comparable by means of default probabilities that arise on account of the division of borrowers into creditworthiness and risk categories. In addition, that proposal provides for the inclusion of expected loss ratios in the event of the borrower's insolvency.

In this proposal, I see some significant common ground with the debate which is now going on in the international arena. In the international supervisory bodies, the German representatives will argue that internal rating systems should initially be applicable only to specific segments of the credit portfolio, so as to make it easier for the banks to introduce this new procedure. Moreover, we will try to ensure that the model is neutral in its effect on competition at both the international and, if possible, the national level.

The question of a good rating system and its credibility is being asked not only by practitioners, but also increasingly by academics. How far the fourteen principles for rating systems drawn up by Prof. Krahnen and Prof. Weber will be generally accepted is hard to tell at the moment. Personally, I have a favourable opinion of that initiative, but the principles must still be discussed in more detail. What is plain, for example, is that external ratings awarded by rating agencies pursue different objectives – namely, a more long-term orientation towards the entire credit cycle – from internal bank ratings. The topic of "completeness" is naturally also of great significance in the case of internal bank

systems. I assume that "partial use" will also be possible here. To that extent, the rating would then be incomplete.

Ladies and gentlemen, the debate on a *rapprochement* of the prudential to the economic capital of banks by the deployment of management instruments of their own naturally involves uncertainties and risks. The "self-assessment" by the banks planned for a substantial part of the risks in the computation of the capital to be maintained in respect of the risks incurred therefore calls for a supervisory audit of the internal bank methods used. It is at this point that the two other pillars of the new Accord come into play. In particular, banking supervisors will be obliged – as stipulated by the second pillar of the discussion paper (the supervisory review process) – to gain a clear idea at first hand of the instruments used in banks' risk controlling and risk management. That applies all the more since the market can hardly function as an external monitoring body for internal bank ratings.

VII

Ladies and Gentlemen,

It is not only at the international level that a "level playing field" must be ensured. That is scarcely less important at the national level as well. As you know, the Basle Accord is primarily applicable to internationally operating banks. On the basis of the Basel proposals, the same subjects are being addressed in Brussels, too, so that ultimately the entire banking sector will be affected by the regulations. After the implementation of a corresponding EU Directive, those provisions will be binding on all credit institutions within the EU.

We advocate, firstly, that the final regulations should coincide in Brussels and in Basel, and should come into effect at the same time. By that means, a duplication of efforts should be avoided by those credit institutions which will have to apply both sets of regulations. Secondly, it is our aim that, in principle, all institutions – regardless of their size – will be able to apply the new regulations. Hence, we welcome the efforts being made by the banking associations to assist their member institutions in implementing internal rating systems. It would be conceivable, for instance, for certain demands of the rating process (e.g. the collection and processing of data) to be satisfied centrally by the associations. That naturally gives rise to questions of definition and implementation. Which element of internal rating can be shifted to outside bodies, such as associations? Each institution's inherent responsibility for its internal rating system must on no account be called into question, and internal ratings must be fully integrated in the in-house decision-making process.

VIII

Allow me to elaborate briefly on a further important feature of the first pillar of the new Capital Accord. This is the area of "risk mitigation", i.e. the use of risk-minimising methods, such as netting arrangements, credit derivatives and the extended authorisation of collateral and guarantees.

What is the connection between risk-minimising methods and ratings?

On the one hand, there is the option of including a risk-minimising method in the internal rating itself by rating the ***probability of loss*** (e.g. owing to collateral) correspondingly lower. On the other hand, risk-minimising measures might make themselves felt ahead of the rating process proper, by reducing the ***credit-risk position***, as a yardstick for the rating, by the risk-minimising measures. Both options are still under discussion. The second variant is likely to be easier, above all for small and medium-sized institutions, i.e. the computation of a "net exposure" ahead of the rating.

IX

Ladies and gentlemen, external and internal ratings should not be viewed in isolation, but in the overall context of the planned new Basle Capital Accord or comparable Brussels regulations. That is to say, especially in the context of other risks to be subjected to capital charges (interest-rate risks and

operational risks), and in the context of the other two pillars. For this is not a matter of individual elements at a technically higher level, but rather a matter of making the financial markets stabler.

X

Let me therefore also say a few words on what is known as the "Supervisory Review Process". The review process is nothing completely new, either in international terms or in Germany. The Federal Banking Supervisory Office can already specify "negative special conditions" and order a capital ratio higher than 8%. Unlike conditions in the United States and United Kingdom, which have long known more comprehensive audit operations for a bank as a whole, in Germany only specific parts of a bank have hitherto been audited by banking supervisors. As examples, I may mention the audits of commercial transactions and of market-risk models. The experience gained in the process may serve as a basis for further deliberations.

The frequency, scale and intensity of audits depend on the size and risk content of the bank. In my opinion, global players therefore require more intensive supervision, since they are more significant in terms of systemic risk.

Two developments are prefigured by the supervisory review process. In the first place, banking supervision will become more individual, since the respective risk profile of the bank will be monitored by the supervisors. That will be as specified with some individual supervisory measures. Secondly, the road is being traversed from a banking supervision primarily based on compliance with quantitative standards to a qualitative form of banking supervision. As is already the case, the supervisory review process may lead not only to the imposition of conditions in specific cases but also to explicitly higher capital ratios, exceeding the present 8% limit. This option must be available as a kind of last resort.

XI

Finally, the Basel edifice is completed by a third pillar, which calls for more extensive disclosure requirements on the part of credit institutions – requirements which are intended to make it easier for the markets to assess risks. Enhanced market transparency is supposed to contribute to greater market discipline. Here, too, there are again direct connections with the other pillars of the Accord.

As far as the issuing of disclosure standards is concerned, however, banking supervisors have no autonomous powers of their own; hence only the legislature can take the appropriate action here. But the supervisors could elaborate a catalogue of requirements which might constitute the basis for legislative measures.

XII

Ladies and Gentlemen, I have attempted to sketch in for you the outlines of a new, uniform global supervisory standard. Let me briefly sum up the principal points once again.

1. More sophisticated risk appraisal and measurement, by the use of external and internal bank rating systems and risk-mitigation techniques.
2. External and internal rating systems should be systems of equal value which, in principle, should be accessible to all institutions and, in my opinion, should be introduced simultaneously.
3. Explicit capital charges for risks that have hitherto been included implicitly in credit risk, for instance, interest-rate risk and other risks.
4. Progress towards a qualitative form of banking supervision based on the individual risk profile of banks.

5. Enhanced market transparency, and thus a buttressing of banking supervision by market discipline.

All these measures should enable supervisors and the market alike to recognise future risks at an early stage, so as to be able to respond in timely fashion and proactively in the interests of preserving the stability of the financial system.

The complex evolution of banking business and the concomitant increase in risk can no longer be coped with by the traditional instruments. The globalisation of the financial markets calls for a departure from purely national rules and regulations, and the adoption of greater flexibility and greater proximity to the bank on the part of supervisors, so as to foster financial market stability. Europe cannot disregard these trends if it wants to hold its own in the international competition for market shares. Furthermore, European banks will have to adjust to the introduction of internal rating systems if they do not wish to get out of touch with the United States in the field of up-to-date techniques of credit-risk management.

Market players and others are called upon to lend a hand in shaping the definitive regulations during the consultation phase that is now in progress and subsequently during the second such period from autumn 2000 onwards. Academic economists, in particular, can likewise help to answer the still unresolved issues posed by the Basle Accord. We should face up to this major challenge, which is not least an intellectual competition for the best proposals, by making a joint effort.