OBSERVATIONS ON THE PAPER BY E. KAPSTEIN

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1. Scope of the paper and organization of comments

- Kapstein's paper focuses on the pressures that have been placed upon regulators by private institutions seeking to achieve a "level playing field" for their global business activities. International co-operation among financial supervisors is defined as a multilateral effort to reconcile diverse demands for both a more level and more stable environment for global finance.

  The contemporary risk environment is charted as the combination - "whether poison or elixir" - of increasing bank consolidation on the one hand and risk atomization on the other. It follows that during future crises it is inevitable that there will be a demand by financial agents for closer co-operation, not just between central bankers and financial supervisors but perhaps with elected officials as well. Kapstein suggests some steps that go in this direction.

- The paper's arguments can be organized around two general themes: the *process* of fulfilling the objective of financial stability (what Kapstein calls the "clubby" approach); and the *gaps* in meeting the financial stability objective (in view of recent developments in the financial system such as the emergence of large, complex financial institutions and the atomization of risk).

- Important for the discussion of each of these themes is the observation that the financial stability mandate has three dimensions: prevention (the regulatory process); surveillance (the macroprudential perspective); and crisis preparation and management. Account should be taken of each of these dimensions when discussing both the process and the challenges of fulfilling the objective of financial stability.

2. The specificity of the BIS process

- My remarks focus on the specific role of the BIS within the framework of the international co-operation among financial supervisors, taking as a starting point the observation made by Kapstein that "the emergence of banks with over USD 1 trillion in assets and a large share of national deposits, coupled by an increasingly opaque market for securities, could be creating a new environment with the capacity to overwhelm the clubby approach to financial regulation that has been built at Basel and elsewhere".

- A club may be described as an informal association of members sharing similar values. The BIS can indeed be qualified as a club, the membership of which consists largely of central bankers. The BIS club draws on and underpins the expertise of its members in different, but interrelated fields, focusing on the functioning and architecture of international financial markets (as witnessed by the four traditional Basel committees, MC/CGFS/BCBS/CPSS).

  The financial strength of a club is also crucial for the exercise of independence and intellectual authority. The BIS combines both of these attributes, as it possesses its own, profitable bank with outstanding expertise in international finance. This allows the BIS to remain independent of the political or other agendas of the moment and to benefit from the bank's knowledge and insights.

  Furthermore, the club has not shut itself in its comfortable premises, but from its start has maintained contacts with private market participants, developing over the years an intense and trustful dialogue with the financial sector. All of these different aspects allow "Basel" to play an important and specific role in the surveillance of the international financial system, covering the overall financial market trends as well as the important market players and infrastructures on which the markets rely.

- Kapstein observes (quoting Robert Rubin), that the globalised financial markets of today's world are not confronted with really globalised authorities. I will not go into the discussion of whether a "universal financial regulator" would be the appropriate answer to recent developments; rather, I would simply point to the fact that a fast and co-ordinated reaction of all the authorities involved is crucial when dealing with a financial crisis. Also in this field, the role of the BIS can hardly be overestimated; the mere fact that the men and women concerned are able to build personal relationships, which can be relied upon in times of crisis, is a major achievement.

- In assessing the Basel process, it would have been useful for Kapstein to take a broader view of the range of activities occurring at the BIS. One of Kapstein's conclusions is that central bankers and financial supervisors must speak more openly about the contemporary risk environment and make clear what it is that they do not know or understand. This type of activity is already occurring at the BIS; through, for example, the focus by the CGFS (and other committees) on developments in financial markets and publication of studies identifying which of the issues are understood and which are not.

3. Evolution of the process

- Contrary to monetary policy, the responsibility for financial stability is shared with other authorities; in particular, supervisors and treasuries. The governance of the process is – unavoidably – complex, and the potential for frictions, both domestic and international, is high, especially given that public money is at stake.

- The "clubby approach" to financial stability described by Kapstein has evolved over time, to fit better with the standards of transparency, accountability, and legitimacy. One of the big successes of the last decennia has been the outreach to financial supervisors, and the concrete results thereof, in particular the Basel I and Basel II agreements.

  It is important to make the distinction between central bankers and financial supervisors. Kapstein quotes Bill White as stating that central bankers and financial regulators around the world may have "more in common" with each other than they do "with various parts of their national governments". I believe that this observation is right, but it is equally true that central bankers and regulators have their own, distinct objectives and instruments, which are complementary as well as partly overlapping.

  Kapstein highlights the pressures that have been placed upon regulators by private financial institutions wishing to shape regulation to their benefit. Indeed, the contacts between regulators and regulated entities in the context of crisis prevention may go beyond the trustful dialogue that is essential to the surveillance process. It is important to ensure that the mix of prevention and surveillance activities at the same institution does not create confusion regarding the difference in "spirit" of the surveillance and the regulatory dialogues.

- The core of the suggestions made by Kapstein relate to building a closer relationship between central banks, financial regulators and elected government officials. Some brief reactions may be useful.

  (i) The politicization of a bailout is not a new phenomenon as such. In the end, the resolution of a financial crisis almost inevitably engages political responsibility and accountability, either because of the use of taxpayers' money or because of the number of affected citizens. This fact of life has led to the full involvement of treasuries in the Financial Stability Forum, and the recent conclusion, at EU level, of a memorandum of understanding among the three parties concerned.

(ii) What is new are the amounts that possibly will be involved, and the increasingly cross-border character of financial crises. These are inevitable consequences of the globalisation of markets. Fortunately, we are living today in another world than in 1968, when the word getting around that US Treasury undersecretary Fred Deming was at the BIS was sufficient for bullion traders to speculate that the U.S. was about to sell its gold and to begin a panic in the market. At the same time, market reactions may not have changed that much; therefore, we should take care to preserve the particular qualities and value added of each institution and forum.

- What is striking about the BIS approach, in my view, is the great predominance of substance over process. It is still in the first instance the substantive value added of the outcome of the Basel process which determines its impact. While the evolution of the BIS process demonstrates the capacity to respond to a more formalized environment with multiple stakeholders, it is essential to preserve the virtues of the "club approach"; namely, informality, confidentiality, and importance of substance over process.

4. Gaps in fulfilling the financial stability mandate

- As Kapstein notes, one of the gaps in financial stability that is emerging in today's financial system is the atomization of risks, via the use by financial institutions of derivatives and other financial products. These risks remain opaque, and the models used to measure them have not yet been tested by a major shock. I would add to this the observation that new instruments of credit risk transfer make it increasingly difficult to track the circulation of risks in the financial system. How to deal with this "tail risk" is a key challenge. Problems are created not only by the opacity of the exposures but also by the fact that many transactions are undertaken with financial institutions such as hedge funds, insurance companies, and securities houses which may not be subject to the same level of regulatory scrutiny as are banks. The absence of a regulatory "level playing field" in this respect may well create an additional threat to financial stability. One of the areas in which the BIS might positively contribute would be further study of the linkages between regulated and non-regulated financial institutions and the degree to which risks that have been transferred off of banks' balance sheets might ultimately return to the banks following a major shock.

- The new financial instruments imply that our financial system has – probably – become more resilient; however, the possible impact of extreme situations may well be greater. These issues are receiving high priority in the BIS Committees. One area of focus is on how to ensure that critical infrastructures can continue to operate under severe stress, such as operational or financial stress, or insolvency. This focus concerns not only infrastructures but also all types of institutions playing a key role in financial markets (e.g., SWIFT and CLS, which provide critical services to many domestic systems). Kapstein rightfully mentions the importance of stress testing exercises. Here, too, work is in progress. Clearly, these issues cannot be addressed in the absence of a close dialogue with government officials.

- Several of the questions raised by Kapstein relate directly to the effectiveness of the Basel accords. With respect to the general issue of the role that the Basel framework plays in safeguarding financial stability, the relevant question to ask is how banking systems would fare in economic downturns *in the absence* of the Basel accords. This type of counterfactual reasoning is difficult, but it is necessary for an accurate assessment of the agreements. The leveling of the playing field among banks achieved by the Basel I accord essentially consisted of raising the capital of the least capitalized banks to levels more consistent with those of the highly capitalized banks. Unless regulatory capital arbitrage was so easy (which is doubtful, since securitization techniques were only initially available to the largest and most well known banks) and so strong so as to have increased the riskiness of the majority of banks, the overall result must have been a strengthening of banks' balance sheets.

- A specific question raised by Kapstein with respect to the Basel II accord is whether it is "well suited to govern or regulate – in the engineering sense of these terms – the structure of risk" arising from developments such as LCFIs and the atomization of risks. As Kapstein observes, the Basel II accord is aimed at better matching capital to risk. Despite the fact that the original impetus for Basel II may have come from the major New York banks, it is hard to deny that one of the positive effects of the new accord has been to stimulate banks to adopt "best practices" of risk management. Many of the banks that are making the investment in risk measurement and management necessary to enable them to adopt the advanced internal ratings approach of Basel II likely would not have done so at this point had it not been for the accord.

- Kapstein rightfully stresses the fact that the Basel framework is not sufficient for regulating LCFIs. The complexities of these institutions, the range of the activities in which they engage, and the speed at which their risk profiles may change warrant a level of supervision that goes above and beyond the rules specified in the Basel I and II agreements. The need for heightened supervision at LCFIs is also related to the silo approach to risk adopted by the Basel framework. Credit, market, and operational risks are treated separately, with little account taken of linkages or interactions between the different categories of risk. Yet, the broader the range of activities a financial institution undertakes, the more likely it is that the effect of a shock in one area (say, market risk) will be counterbalanced by or feed back into another area (e.g., credit risk). At the same time, it is important to keep in mind that the principal explanation for the silo approach to risk measurement adopted in the Basel framework is that the technology for integrating the measurement of credit, market, and counterparty risks is still at an embryonic stage. To the extent that such technology can be developed and shown to be reliable, it should be integrated into the future Basel framework. Indeed, the topic of integration of risk measurement is currently under study within task forces of the Basel Committee.

  While I agree with Kapstein that the Basel framework is not sufficient for regulating LCFIs, I believe that Kapstein's view of the Basel II accord is too narrow. The implicit focus of all of the discussion is on Pillar I. Importantly, Pillars II or III are designed to deal with some of the situations cited by Kapstein to illustrate failings of the accord. For example, while it is true, as Kapstein notes, that the regulatory capital rule specified in Pillar I (which may assign a lower risk weight to mortgage loans than to loans to firms) will be insufficient to control the risk of a consolidated bank which has specialized completely in mortgage lending, Pillar II is designed to specifically address this case. The supervisory review envisioned by Pillar II allows regulators to impose higher capital requirements to cover the risk of excessive concentration in banks' loan portfolios.

  Pillar II also foresees regulators assessing the degree to which instruments of credit risk transfer actually accomplish a transfer of risk off the balance sheet of the institution. Although structured finance instruments allow banks to transfer "tail" risk to other institutions, most of the risk (expected loss) often remains with the bank. Pillar II allows regulators to adjust capital requirements for such circumstances.

  Finally, Pillar III of the Basel II accord is an implicit acknowledgement by regulators of the complexity of regulating modern financial institutions and of the potential value that market discipline can provide, as a complement to regulation.

- The challenges for the Basel II framework are well known. One, as stressed by Kapstein, is to keep regulation as close as possible to rapidly evolving risk management technology. However, this is not Basel III; it is Basel II. The Basel Committee states in the new accord that "The Committee has designed the revised Framework to be a more forward-looking approach to capital adequacy supervision, one that has the capacity to evolve with time. This evolution is necessary to ensure that the Framework keeps pace with market developments and advances in risk management practices, and the Committee intends to monitor these developments and to make revisions when necessary."

Interestingly, the development of new financial products such as collateralized debt obligations, while contributing to the current difficulty of tracking and controlling risk in the financial system, may further the advancement of the technology of risk measurement. CDO and other structured finance markets are at the forefront of development of models and techniques for assessing portfolio risk (credit, market, operational, etc.). These markets offer a testing ground for techniques that may eventually be adopted by financial institutions for their internal use. An evolving Basel framework may well profit from the same innovations which currently limit the scope of Basel II.

In summary, the complexity of the issues relating to financial stability should not be underestimated. The role of authorities in maintaining financial stability involves several dimensions: prevention, surveillance and crisis management. The process of implementing the mandate of financial stability requires independence, accountability, transparency, and effectiveness. Finally, multiple actors are involved: central banks, regulators and government officials. Within this complex framework, each actor has its own role to play and value of a specific nature to add. The spirit of adaptability and learning which the BIS represents places it in a unique position to foster value creation in all of these areas.

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