William J McDonough: Update on the major initiative to revise the 1988 Capital Accord

Speech by Mr William J McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the 4th Annual Supervision Conference of the British Bankers Association, held in London, on 19 June 2000.

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I am pleased to be with you to provide an update on the major initiative to revise the 1988 Capital Accord. Last June the Basel Committee on Banking Supervision, which I have the privilege of chairing, released a Consultative Paper proposing a new capital adequacy framework. My comments today will focus on the industry's response to the proposal and the areas that will require the Committee's attention going forward. Given the progress already achieved, it is my belief that the Committee will be prepared to release a second Consultative Paper early next year.

I will also briefly discuss three essential aspects of the safe and sound operation of any banking organization - good corporate governance, rigorous internal controls and effective risk management. I will conclude with some thoughts on the critical role of banks' board of directors and senior management.

Current Accord

The primary tool of capital regulation currently is the set of minimum ratios that were devised in 1988 by the Basel Committee. The 1988 Capital Accord has truly become a global standard for banks worldwide. Its adoption by over 100 countries has helped to strengthen the safety and soundness of the international banking system and has contributed to the achievement of competitive equality.

However, the financial world has changed dramatically over the past dozen years, to the point that the Accord's efficacy has eroded considerably. Its broad brush approach to differentiating credit risk encouraged banks to undertake regulatory arbitrage transactions. Furthermore, as banks have developed innovative techniques for managing and mitigating risk, credit risk now exists in more complicated, less conventional forms than is recognized by the 1988 Accord, thus rendering capital ratios, as presently calculated, less useful to banking supervisors.

Today's marketplace also provides an imperative for revising the 1988 Accord. The rapid pace of technological change places information that was once largely the domain of analysts and institutional investors into the hands of millions of individual investors and consumers. Market participants, armed with timely and meaningful information, reward sound risk management practices and penalize those banks that are found deficient in this area. A bank's regulatory capital position can be a strong indicator of how it supports its risk, and if markets are to impose an optimal level of discipline on banks, we must ensure that regulatory capital measures reflect risk as precisely as possible. I believe that reform of the Basel Accord is thus clearly in the markets' best interests. As the Committee continues to develop a more risk-sensitive capital adequacy framework, we cannot lose sight of the need to keep the Accord up to date.

Progress in revising the Accord

Let me take a few moments to tell you how our work on the Basel Accord is progressing. The Committee began a fundamental review of the Accord in 1998. The release last June of the Consultative Paper reflected our vision for a new capital adequacy framework and we asked for comments from the broad marketplace.

We knew that our first Consultative Paper would not be a perfect framework for all banks. That is why we have been so keen to obtain feedback from a wide variety of sources including financial institutions, central banks and supervisors, representatives from non-G10 countries and other market participants. The formal comment period on the Consultative Paper ended on 31 March. We are very pleased and encouraged by the response, and are now in the process of considering more than 200 comments received.

The commentators have sent us a strong message that they endorse our overall goal of developing a capital framework comprised of three pillars - minimum capital standards, supervisory review and market discipline - that is more risk reflective and appropriate to banks of varying levels of sophistication.

Internal ratings-based approach

Based on our evaluation of the comments received, I can tell you that we are more committed than ever to an internal ratings-based approach. Many in the industry noted that a capital regime based on banks' internal ratings, which reflect a wide range of information about borrowers, can prove to be quite sensitive to the level of risk in a bank's portfolio.

Our analysis indicates that a wider range of institutions could be eligible to use the internal ratings approach, than the narrower set of large and sophisticated institutions, as implied in the Consultative Paper issued in June. We now envision extending the applicability of the internal ratings method approach to banks of varying sizes, including small and medium-sized institutions provided such ratings systems are accompanied by strong internal controls, supervisory oversight and ample disclosure.

With this in mind, the Committee is working on how to link banks' internal ratings to a regulatory capital scheme. We are seeking to develop flexible approaches, since all banks wishing to use internal ratings may not yet be able to generate the full amount of information necessary to tie their ratings to capital requirements. Thus, for at least some banks, we are considering the possibility that some information would be supplied by the supervisor, although the core elements would be generated by a bank's internal ratings scheme. There would be a parallel track for the more sophisticated institutions, which would rely fully on internal information. In practice, the two approaches are part of a single evolutionary framework, in which banks can rely increasingly on internal processes for regulatory capital allocation as their risk measurement and management practices improve.

As a first key step in developing these approaches, the Basel Committee gathered information about banks' internal ratings systems. Our findings indicate that there is presently no single standard for the design and operation of such a system. Thus, I see the importance of establishing appropriate guidelines for the use of internal ratings systems. These guidelines should ensure that internal ratings appropriately reflect the credit risk in each category of exposure. Additionally, it is important that we develop robust disclosure guidelines for internal ratings information to ensure that capital requirements are comparable across banks and countries.

Standardized approach

A revised standardized approach is still very important to us at the Basel Committee, as some banks may not have the internal resources to implement an internal ratings-based approach, and some supervisors have indicated that implementation of this approach would create resource strains for them. Further, we want to ensure that those banks that look to the Accord as the common standard - many of which are located in emerging market countries - can subscribe to the revised framework.

In order to improve the risk sensitivity of the standardized approach without becoming overly complex, the Committee has proposed the use of external credit assessments, such as credit ratings. Many comments noted drawbacks to this approach, but those that have seriously considered the trade-off between simplicity and risk sensitivity generally have agreed with the Committee's decision to make use of external credit assessments. This is particularly true for sovereign credits where there is widespread support for finding an alternative to the current OECD/non-OECD distinction. In other words, OECD membership would no longer be relied on for setting regulatory capital for sovereign or bank claims.

Notwithstanding this support, many commentators have offered modifications to the Committee's proposed standardized framework, which several observers have suggested does not go far enough toward risk differentiation. The Committee has taken this concern to heart, and is actively evaluating whether it would be feasible to incorporate additional risk weights into the standardized approach, and, if so, how this should be done.

As we work toward greater risk differentiation among claims that are rated, we will continue to give extensive thought to the treatment of unrated claims, given that the penetration of external ratings remains low in most countries. It is difficult to avoid creating incentives to remain unrated while at the same time retaining continuity with the existing Accord's treatment for these credits. Further work would be needed to develop a standard for unrated claims that would be more risk-reflective but, unfortunately, few commentators offered significant suggestions in this regard.

Procyclicality

The Committee has considered what some observers have noted is the potential for introducing greater cyclicality in a more risk-sensitive capital framework. That is, the capital requirements for loans to troubled borrowers will tend to increase at just the point when such trouble is becoming apparent.

This is an important point, and one that must be given serious consideration. It is my view that the global financial system needs to move toward addressing potential credit problems preemptively - before these problems have time to grow from minor disturbances to major disruptions. A more risk-sensitive capital framework should help ensure that banks hold appropriate capital behind high-risk credits in the first place, and thus reduce the tendency for accentuating the need for capital after problems arise with such loans.

Credit risk mitigation techniques

Greater recognition of the benefits of risk mitigation techniques - such as collateral, guarantees, credit derivatives and netting - also is at the forefront of the Committee's work in revising the Accord.

In January of last year, the Committee held consultations with over 50 banks and industry associations within the G10 on their methods for mitigating credit risk. We are now evaluating how to incorporate the risk-reducing benefits of the best of these practices, while at the same time addressing potential risks that remain from their use.

As we finalize our proposals for making capital charges reflective of risk mitigation techniques, we are striving to find the right balance between recognizing a material reduction of risk with a structure that is applicable beyond internationally-active banks to both domestic and non-G10 banks. While we recognize that the treatment of credit risk mitigation techniques might differ in some respects between the standardized and the internal ratings-based approaches, we want to ensure a high degree of consistency between the two.

Interest rate and other risks

The Committee recognizes that in refining the measurement of credit risk, we should also take the opportunity to explore the potential coverage of other important risks, such as interest rate risk in the banking book and operational risk.

For interest rate risk, we are pursuing a methodology that would require a capital charge only for so-called "outlier" banks whose interest rate risk is significantly above average. The envisioned framework for determining "outlier" banks for interest rate risk is similar to the general framework for credit risk - the most sophisticated banks would use internal measurement systems for assigning capital, while banks without sufficiently robust internal systems would use a simple standardized approach. The Committee is still working out a number of issues on this topic, including the definition of an "outlier" bank and supervisory assumptions that would need to be built into the standardized approach.

The Committee, through its Risk Management Group, also is engaged in the development of a capital requirement for other risks, in particular operational risk. Over the past year, it has met with numerous banks and industry associations including the British Bankers' Association. These meetings have allowed us to better understand the range of practices currently in use. Over the next year, the Risk Management Group will work with the industry to develop an evolutionary framework comprised of approaches of varying sophistication, ranging from a simple to an internal-based method. We are particularly interested in creating the right incentives through a set of robust criteria that will enable banks, subject to supervisory approval, to employ increasingly sophisticated approaches for setting capital requirements for other risks.

Second and third pillars

Let me also briefly touch upon the two other pillars of the revised capital adequacy framework - supervisory review and market discipline. These topics are certainly familiar and important ones to all of you.

Supervisory review of capital is a critical complement to minimum capital requirements. The Consultative Paper proposes that supervisors should ensure that each bank has sound internal processes in place to assess the adequacy of its capital, based on a thorough evaluation of its risks. I want to stress that this proposed approach in no way intends to replace the judgement and expertise of bank management, or to shift responsibility for capital adequacy to supervisors. On the contrary, it is well understood that bank managers have the most complete understanding of the risks their institutions face, and it is they and the bank's board of directors who have primary responsibility for managing those risks.

The task for supervisors in this framework is to evaluate how well banks are assessing their capital needs relative to their risks, including whether banks are appropriately addressing the relationship between different types of risks. Most importantly, in proposing this second pillar the Committee intends to foster a more active dialogue between banks and their supervisors, such that when deficiencies develop, prompt and decisive action can be taken to restore capital. The Committee currently is in the final stages of preparing a paper on how the supervisory review of capital can be implemented effectively.

The third pillar of the new capital adequacy framework, market discipline, will serve to reinforce capital regulation and other supervisory efforts to promote safety and soundness in banks and financial systems. The Committee, in January of this year, issued a paper on bank disclosures, covering banks' capital structures, risk exposures and capital adequacy. Currently, our Transparency Group is considering whether it is possible to establish a set of core disclosures that would bolster market discipline. This will involve drawing upon our existing disclosure recommendations, and reviewing the extent to which disclosure in new areas - the internal ratings-based method, external ratings or internal assessment of other risks - might be appropriate.

I hope that this overview has given you a sense of the key points the Committee has learned from the consultative process, and where we are headed. In the near-term, we are completing our work and expect over the next few months to make progress in a number of areas, including greater risk differentiation in the standardized approach and the development of supervisory standards for internal ratings.

As we continue to fine-tune the new capital adequacy framework, we also are striving to avoid getting bogged down in secondary issues that could slow down the overall process. As I have often remarked, the perfect cannot be the enemy of the good. It is imperative that we stay on track in our goal to release a new capital adequacy framework by early next year, with a comment period and industry implementation to follow shortly thereafter.

Corporate governance

My remarks thus far have focused on the need for a more risk-reflective capital framework. Clearly, a strong capital position is crucial to the sound operation of any banking organization. It allows banks' board of directors and senior management to focus on strategic objectives and growth opportunities, supports the business activities of the organization, and provides the financial strength necessary to sustain the occasional losses that are inevitable in a business of taking calculated risks.

In this latter sense, capital represents the last line of defense against potential loss-creating problems. But, I want to briefly address the first line of defense - effective bank management, which increasingly is an important element of today's supervisory framework as banks' activities and their associated risks become ever more complex.

There are several aspects to effective bank management. The importance of good corporate governance cannot be overemphasized. Broadly speaking, corporate governance refers to the organizational infrastructure necessary to achieve a workable corporate strategy, to effectively implement that strategy, and to continually evaluate its risks and benefits to the organization. These basic infrastructural elements include:

- independent and competent outside directors;
- capable and experienced management;
- a coherent corporate strategy and business plan; and,
- clear lines of responsibility and accountability.

There are three key points that are closely related to good corporate governance and critical to any banking institution. The first is a rigorous internal control apparatus, which is essential to the sound and successful execution of banks' strategic objectives. Second, each banking institution must have in place the technical systems and management processes necessary to identify the risks associated with its activities. Third, an effective risk management and control structure must be accompanied by the institutional management culture required to ensure that policies and procedures are translated into practice, with buy-in at all staff levels.

Primary responsibility for ensuring that the bank has in place good corporate governance, rigorous internal controls and effective risk management lies with the board of directors and senior management. The task of the board of directors is to oversee the development of the overall strategy of the organization and the decisions made by senior management in pursuit of that strategy. The role of senior management, in turn, is to assure that day-to-day decisions made within the organization are consistent with the policies and long-term objectives of the board. With regard to the board of directors, I recognize that it can be difficult to elect members with the necessary skills and time to devote to overseeing the bank. While this can be a major challenge, it is obviously important that we get it right for the overall well-being of the bank.

Conclusion

In closing, I want to emphasize that effective supervision of modern banking organizations will necessarily entail a closer and more cooperative partnership between industry participants and official supervisors. The industry's participation in the formulation of a more risk-sensitive capital adequacy framework is a good example of this kind of constructive interaction. Indeed, the three pillars of the proposed framework - minimum standards, supervisory review of banks' capital assessment methodologies, and market discipline - reflect the understanding that regulatory requirements alone are no longer sufficient to address the growing complexity of banks' activities and the associated risks. Consistent with this notion is the need for effective corporate governance, which plays an increasingly important role in a rapidly evolving banking environment.

It is clear to me, as a former commercial banker and now as a supervisor, that only if the industry and supervisors work together, each meeting our responsibilities and reinforcing the other, will we be able to successfully manage and supervise a modern financial system. While perspectives may differ from time to time, our objective is the same - to maintain a strong and vibrant financial system over the long term.