Andrew Crockett: Speech upon receiving the European Banker of the Year 2001 award

Speech by Mr Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the Financial Stability Forum, upon receiving the European Banker of the Year 2001 award, Frankfurt, 25 April 2001.

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Lord Mayor, President Duisenberg, distinguished guests.

Let me begin by saying how honoured I feel to be chosen to receive this prestigious award. It is a particular honour to follow in the footsteps of such a distinguished group of predecessors, and to receive the award from such an eminent central banker as Wim Duisenberg, whom I have been proud to count as a friend and mentor for many years.

And it is a pleasure to be here in Frankfurt for the ceremony, and to have present so many friends and colleagues from the German banking community.

I realise that awards such as this one are all, to some extent, proxy awards. That is particularly true in my case. My presence here symbolises the growing importance of the role played by central banks in our economies, and the position of the BIS as the instrument of international central bank cooperation. For that, many people deserve credit, not least Wim Duisenberg, past President of the BIS, and both his predecessor and mine in our respective functions, Alexandre Lamfalussy.

The BIS has become widely associated in the public mind with banking supervision. If I say a few words on this topic today, it should not detract from the crucial part the BIS has played in central banks' efforts to restore price stability, to say nothing of its role over many years as a patient promoter of European monetary cooperation.

When I began my career, some 35 years ago, banks operated in a much less complex environment than they do today. In the mid-1960s, banks were the predominant financial institutions in largely domestic markets. They had a common business model in which traditional core services were jointly provided. Competition was limited by custom and regulation. Branches were the key vehicle for attracting and servicing clients. Cross-border banking was in its infancy.

By now, much of this has changed. Business models have become more diverse: some banks offer a full range of services to wholesale and retail clients, others specialise in niche products. The products that used to be offered jointly by banks can now be unbundled and provided separately by independent service providers who may not themselves be banks.

This has gone hand in hand with an enormous increase in competition, of various kinds: competition between banks in the same national market; competition across geographic boundaries; competition between banks and non-bank financial intermediaries, and competition between banks and non-financial firms. Intensified competition has been both the cause and consequence of the liberalisation and globalisation of financial activity. At the same time, there has been a notable increase in the volatility of the financial environment.

All this has profound implications for banking practitioners: for those who manage banks and those who have to regulate them. Bank managements have to maximise shareholder value in an increasingly difficult and uncertain environment. Bank regulators have to juggle the objectives of efficiency, competitive equity and a safe and sound financial system.

The challenge to banks can be put quite simply: it is to find a business model that provides competitive returns to shareholders, while retaining the confidence of depositors and counterparties.

How to meet this challenge in practice is of course much more complex. And it is made all the more so by the dynamic evolution of the competitive environment. Who can tell with confidence which financial products will be in demand five years from now? Who can predict the technology by which they will be produced and delivered? Yet decisions made today have to embody assumptions in all these domains, if not with precision, at least with regard to the direction of change.

Different institutions will choose different futures for themselves. Some are choosing to focus on the profitable, if unexciting, business of servicing domestic retail clients. Others see a more promising future in shedding retail activities and focussing more heavily on corporate finance.

Some banks believe that the integration of banking and insurance activities offers important opportunities to exploit synergies and diversify risks. At the retail level, the rationale is that delivery channels developed for banking services can be cheaply exploited to deliver other financial products. At the wholesale level, banks following the integrated strategy believe that the provision of an assured credit source will help them with mandates for other forms of corporate finance, possibly with fatter profit margins.

Next, there is the question of the appropriate geographic scope of activities. Most banks of any size believe they have to follow their domestic corporate customers when they develop significant activities abroad. This is a different thing, however, from providing a comprehensive range of services in all major financial centres. The number of institutions that can do this is relatively small, probably not more than a dozen, in my judgement. The problem is, there are probably twice that number that aspire to be in such a select group. This implies that the competition and consolidation that has characterised the industry in the past decade still has some way to go.

Last, but certainly not least, a question hanging over the financial sector is the speed and scope of changes to be brought about by the internet revolution. Certain financial activities are being transformed by the new technology quite quickly. This includes securities broking and foreign exchange. In other areas, (traditional banking is one), change is occurring more gradually. But this does not mean that its scope could not be significant.

In adapting to the changes in the financial landscape, the objective of central banks and other regulatory authorities has been to allow the financial system to be responsive to the needs of the real economy, while preserving a level playing field among financial institutions, and making sure that intermediaries operate in a prudent way.

This has required a change in the focus of regulation – away from prohibitions and administrative restraints on balance sheets, and towards prudential requirements that focus on the management of risk. Away, that is from regulation, and towards supervision.

This journey has been a lengthy one, and it is not yet complete. An early step was the original Basel capital accord of 1988, with its focus on the concept of risk-based capital requirements. The latest is the revised accord, with its greater reliance on internal risk measurement, and its emphasis on two additional “pillars” for capital adequacy – supervisory review and market discipline. In between these landmark documents, there has been a vast array of official guidance on risk management practices.

This is not the place to comment in detail on the latest proposals from the Basel Committee. But I think it is worthwhile to make two points of a more general nature. One concerns the “style” according to which individual institutions are supervised. And the other concerns the balance between the regulation of individual institutions and the goal of systemic stability.

Concerning the “style” of supervision, public authorities have become increasingly aware of the need to make regulation conform to market realities, rather than the other way round. Going against the grain of market forces will create or entrench inefficiencies that reduce the capacity of the financial system to serve the needs of its users. It will also be ultimately fruitless, since the ingenuity of financial engineers to avoid burdensome restrictions will always run ahead of the capacity of regulators to close loopholes.

The objective of modern prudential regulation is not to control arbitrarily the activities of financial intermediaries, but rather to ensure that risks that are inherent in all economic activity are sensibly managed and that an adequate cushion of capital is maintained to cover unexpected losses. Supervisors therefore have to understand the business of the institutions they supervise, and the opportunities and risks to which they are exposed.

This change in focus is placing a premium on new skills within supervisory authorities: the tools of economists, consultants and business managers are taking their place alongside the more traditional disciplines of law and accounting. This has important implications for the recruitment policies of official bodies, to say nothing of compensation practices. Good supervision means the need for top-class supervisors. And this is ultimately in the interests of the industry too.

My second point has to do with the focus of the oversight activities of the prudential authorities. The job of a regulator should not be to prevent any and all business failures. To attempt to do so would mean that banks would have to conform to excessively costly prudential standards. Business would then tend to slip away to unregulated channels of intermediation. The end result would be a distorted competitive structure and a riskier, not a safer, financial system. The task of supervisors, and in particular of central banks, is to ensure the stability of the financial system at large. By that, I mean the capacity of the system to continue to provide intermediary functions to the wider economy.

If supervisory oversight were exclusively conducted institution by institution, it would miss some of the most common sources of systemic risk. Widespread instability usually arises not from idiosyncratic problems but from shared exposure to common risk factors. The financial cycle is the most common.

Typically, the upswing of a financial cycle results in an acceleration of credit expansion and rising asset prices. The two feed on each other, since credit expansion causes asset prices to rise, and rising asset prices justify increased lending. Eventually, however, something happens to prick the bubble and the process goes into reverse. As asset prices fall, bad loans are revealed. If adequate capital cushions have not been built up, failures occur, and can be system-wide in their incidence.

Stopping this cycle is not easy. But it is an essential part of the task public authorities now face to build a more robust financial architecture. We will certainly have to encourage financial firms to improve their risk management at an institution level. Beyond this, however, thought is called for on how to moderate the credit cycle that lies behind the fluctuations in asset prices. Incentives are needed to encourage banks and other financial institutions to build up capital cushions in good times, in order better to protect themselves, and the wider economy, when the bad times arrive. We certainly cannot be satisfied with the volatile financial cycles that seem to characterise liberalised financial systems.

Let me end by saying something about the international dimension. It has become a commonplace to say that we live in a globalised economy. Nowhere is this more true than in the financial system. An integrated global financial system has brought many advantages: capital is mobilised and allocated more efficiently; the spread of technological advance is more rapid; and disciplines over unsustainable policies are more effective.

Yet globalisation has also brought deeper and more widespread financial crises. Contagion has meant that disturbances that were previously localised now have wider repercussions. This places a greater premium on effective international mechanisms of crisis prevention and response. Recognition of this fact lies behind the ongoing debate on strengthening the international financial architecture.

Today’s financial architecture is based on the operation of liberalised markets. It is market forces that determine such key features of the international financial system as exchange rates, the availability of liquidity, capital flows and the balance of payments adjustment process. When instability occurs, it can usually be traced to market imperfections and failures.

To address these issues, the international community has embarked on an ambitious effort to develop standards and codes of best practice in financial markets. These codes cover the prudential behaviour of financial intermediaries, such as banks; the transparency requirements for efficient market functioning; and the need for an effective financial infrastructure in contract law, accounting, payments systems, and so on.

Success in this endeavour will require ongoing cooperation across regulatory jurisdictions, and between the public and private sectors. The Financial Stability Forum, set up following recommendations by Hans Tietmeyer, has the capacity to make such cooperation a reality. If it does so, I believe it can make a substantial contribution to building a more robust international financial system.

All this is a substantial agenda for the future. It is an agenda that requires the common efforts of the private sector, which provide the innovative spark for the development of new techniques, and the public sector, which needs to make sure that the right incentives are in place to allow efficiency and stability to be mutually consistent.