Mr. de Swaan addresses capital adequacy regulation and the road ahead

Speech by Mr. Tom de Swaan, an Executive Director of the Netherlands Bank, at the conference 'Financial Services at the Crossroads: Capital Regulation in the 21st Century' in New York 27/2/98.

Introduction

1. Ladies and gentleman, it is a great pleasure for me to be here and to participate in the discussion on the future of capital adequacy regulation. I would like to compliment the organizers of this conference on the programme they have set up, covering many relevant topics, and the range of experts they have been able to bring together. In my address, as I am sure you would expect, I will approach the issues from a supervisory perspective. Most of the questions that arise are quite complicated and many issues will require careful review. So do not at this stage expect me to provide clear answers on specifics. I do hope to be fairly explicit, however, on some of the more general issues at stake, in particular on the level of capital adequacy required for prudential purposes. In other words, my address today should be seen as part of the exploratory process that should precede any potentially major undertaking.

Starting point

2. Obviously, our starting point is the Capital Accord of 1988. It is commonly acknowledged that the Accord has made a major contribution to international bank regulation and supervision. The Accord has helped to reverse a prolonged downward tendency in international banks' capital adequacy into an upward trend in this decade. This development has been supported by the increased attention paid by financial markets to banks' capital adequacy. Also, the Accord has effectively contributed to enhanced market transparency, to international harmonization of capital standards and thus, importantly, to a level playing field, within the G-10 countries and elsewhere. Indeed, virtually all non-G-10 countries with international banks of significance have introduced, or are in the process of introducing, arrangements similar to those laid down in the Accord. These are achievements that need to be preserved.

3. It is often said that the Accord was designed for a stylized (or simplified) version of the banking industry at the end of the 1980s and also that it tends to be somewhat rigid in nature. Elements, by the way, that have enabled it to be widely applicable and that have contributed to the greater harmonization. Since 1988, on the other hand, banking and financial markets have changed considerably. A fairly recent trend, but one that clearly stands out, is the rapid advances in credit risk measurement and credit risk management techniques, particularly in the United States and some other industrialized countries. Credit scoring, for example, is becoming more common among banks. Some of the largest and most sophisticated banks have developed credit risk models for internal or customer use. Asset securitization, widespread already in US capital markets, is growing markedly elsewhere and the same is true for the credit derivative markets.

4. Against this background, market participants claim that the Basle Accord is no longer up-to-date and needs to be modified. As a general response, let me point out that the Basle Accord is not a static framework, but is being developed and improved continuously. The best example is, of course, the Amendment of January 1996 to introduce capital charges for market risk, including the recognition of proprietary in-house models upon the industry's request. The Basle Committee neither ignores market participants' comments on the Accord, nor denies that there may be potential for improvement. More specifically, the Committee is aware that the current treatment of credit risk needs to be revisited so as to modify and improve the

Accord, where necessary, in order to maintain its effectiveness. The same may be true for other risks. but let me first go into credit risk.

Objectives

5. Before going on our way, we should have a clear idea of what our destination is. One of the objectives for this undertaking is, at least for supervisors, that the capital standards should preferably be resilient to changing needs over time. That is, ideally, they should require less frequent interpretation and adjustments than is the case with the present rules. Equally desirable is that capital standards should accurately reflect the (credit) risks they insure against, without incurring a regulatory burden that would ultimately be unproductive. Substantial differences between the risks underlying the regulatory capital requirements and the actual credit risks would entail the wrong incentives. These would stimulate banks to take on riskier loans within a certain risk category in pursuit of a higher return on regulatory capital. In order to obtain a better insight into these issues, banks' methods to determine and measure credit risk and their internal capital allocation techniques should be investigated. In doing so, however, we should not lose sight of the functions of capital requirements [as discussed in the preceding session].

6. Capital requirements foster the safety and soundness of banks by limiting leverage and by providing a buffer against unexpected losses. Sufficient capital also decreases the likelihood of a bank becoming insolvent and limits - via loss absorption and greater public confidence - the adverse effects of bank failures. And by providing an incentive to exercise discipline in risk-taking, capital can mitigate moral hazard and thus protect depositors and deposit insurance. Admittedly, high capital adequacy ratios do not guarantee a bank's soundness, particularly if the risks being taken are high or the bank is being mismanaged. Therefore, supervisors consider a bank's capital adequacy in the context of a host of factors. But the bottom line is that capital is an important indicator of a bank's condition, also for financial markets, and minimum capital requirements are one of the essential supervisory instruments.

Guiding principles

7. Therefore, it should be absolutely clear that, when it assesses the treatment of credit risk, the Basle Committee has no intention whatsoever of reducing overall capital adequacy requirements, maybe even the contrary. Higher capital requirements could prove necessary, for example, for bank loans to higher-risk countries. In fact, this has been publicly recognized by bank representatives in view of the recent Asian crisis. More generally, we should be aware of the potential instability that can result from increased competition among banks in the United States and European countries in the longer run. And we should not be misled by the favourable financial results that banks are presently showing, but keep in mind that bad banking times can - and will - at some point return. In those circumstances, credit risk will turn out to be inflexible, difficult to manage and undoubtedly the primary source of banks' losses. Absorption of such losses will require the availability of capital. A reduction of capital standards would definitely not be the right signal from supervisors to the industry, nor would it be expedient.

8. Of course, I am aware of the effects of capital standards on the competitiveness of banks as compared to largely unregulated non-bank financial institutions, like the mutual funds and finance companies in the United States. Admittedly, this is a difficult issue. On the one hand, too stringent capital requirements for banks would impair their ability to compete in specific lending activities. On the other hand, capital standards should not per se be at the level implicitly allowed for by market forces. Competition by its very nature brings prices down, but, alas, not the risks. If competitive pressures were to erode the spread for specific instruments to

the point where no creditor is being fully compensated for the risks involved, prudent banks should consider whether they want to be involved in that particular business in the first place. It is therefore up to supervisors to strike the optimal balance between the safety and soundness of the banking system and the need for a level playing field. In the longer run, efforts should be made to harmonize capital requirements among different institutions conducting the same activities, or at least to bring them into closer alignment.

9. Another principle that the Basle Committee wants to uphold is that the basic framework of the Capital Accord, i.e. minimum capital requirements based on risk-weighted exposures, has not outlived its usefulness. Put differently, it should be maintained as much as possible. The main reason is that this system of capital requirements applies - and will continue to apply - to the large majority of G-10 banks and *a fortiori* to banks elsewhere. Precisely because the Capital Accord is relatively simple, the framework is useful for banks and their supervisors in emerging market countries, and contributes to market transparency.

10. At the same time, it should be acknowledged that the current standards are not based on precise measures for credit risk, but on proxies for it in the form of broad categories of banking assets. Indeed, banks regularly call for other risk weightings of specific instruments. In order to obtain more precise weightings, the Basle Committee is willing to consider less arbitrary ways to determine credit risks. But it is unrealistic to expect that internationally applicable risk weightings can be established, that accurately reflect banks' risks at all times and under all conditions. Compromises in this respect are inevitable.

Credit risk models

11. In the longer run, a way out may be to refer to banks' own methods and models to measure credit risk, under strict conditions analogous to the treatment of market risks. At present, I would describe credit risk models as still being in a development stage, although the advances that some banks have made in this area are potentially significant. Ideally, as sound credit risk models bring forward more precise estimates of credit risk, these models will be beneficial for banks. Models can be used in their commercial operations, e.g. in pricing, in portfolio management or performance measurement, and naturally in risk management. The quantification that a model entails implies a greater awareness and transparency of risks within a bank. More precise and concise risk information will enhance internal communication, decision-making and subsequent control of credit risk. Also, models enable banks to allow for the effects of portfolio diversification and of trading of credit risks or hedging by means of credit derivatives. So, it can be assumed that a greater number of banks will introduce credit risk models and start to implement them in their day-to-day credit operations, once the technical challenges involved in modelling have been solved.

12. The more difficult question is whether credit risk models could be used for regulatory capital purposes, similar to the way that banks' internal models for market risk are already being recognized. As should be clear from what I have just said, credit risk models can have advantages from a prudential point of view. For this reason, the Committee is conscious of the need not to impede their development and introduction in the banking industry. However, there are still serious obstacles on this road. Firstly, credit risk models come with substantial statistical and conceptual difficulties. To mention just a few: credit data are sparse, correlations cannot be easily observed, credit returns are skewed and, due to the statistical problems, back testing in order to assess a model's output may not be feasible. Clearly, there are model risks here. Secondly, if models were to be used for regulatory capital purposes, competitive equality within the banking industry could be compromised. Because the statistical assumptions and

techniques used differ, it is very likely that credit risk models' results are not comparable across banks. The issue of competitive equality would be complicated even further by the potential differences in terms of required capital between banks using models and banks using the current approach. Thirdly and most importantly, a credit risk model cannot replace a banker's judgment. Models don't manage. A model can only contribute to sound risk management and should be embedded in it. This brings me to conclude that if credit risk models were to be used for regulatory capital purposes, it is highly unlikely that they will be judged in isolation. Supervisors will almost certainly also wish to carefully examine the qualitative factors in a bank's risk management.

Market risk - pre-commitment approach

13. Let me now make a short detour and discuss the supervisory treatment of risks other than credit risk. First market risk. Although the internal models approach was introduced only recently, research work is going on and possible alternatives to this approach are being developed. The Federal Reserve, for instance, proposed the pre-commitment approach [discussed yesterday]. Its attractive features are that it incorporates a judgement on the effectiveness of a bank's risk management, puts greater emphasis on the incentives for a bank to avoid losses exceeding the limit it has pre-determined and reduces the regulatory burden. In my opinion, however, under this approach, too, a bank's choice of a capital commitment and the quality of its risk management system still need to be subject to supervisory review. And there are a number of other issues that are as yet unsolved, e.g. the comparability across firms as the choice of the pre-commitment is subjective, the role of public disclosure and the supervisory penalties, which are critical to the viability of the approach. For these reasons, international supervisors await with interest the results of the New York Clearing House pilot study.

Other risks

14. Now, let me turn to the other risks. If one leaves aside the recent Amendment with respect to market risks, it is true to say that the Capital Accord only deals explicitly with credit risk. Yet, the Accord provides for a capital cushion for banks, which is meant to absorb more losses than just those due to credit risks. Therefore, if the capital standards for credit risk were to be redefined, an issue that cannot be avoided is how to go about the other risks. Interestingly, awareness of, for instance, operational, legal and reputational risks among banks seems to be increasing. Some banks are already putting substantial efforts into data collection and quantification of these risks. Not surprisingly then that the Basle Committee will also be considering the treatment of the risks that are at present implicitly covered by the Accord, such as those just mentioned and possibly including interest rate risk. In this process, it will be important to distinguish between quantifiable and non-quantifiable risks and their respective supervisory treatment. More specifically, the Committee will have to consider whether it should stick to a single all-encompassing capital standard embracing all risks, including market risks, or to a system of capital standards for particular risks, i.e. the quantifiable ones, in combination with a supervisory review of the remaining risk categories. From a theoretical point of view, one capital standard might be preferable, since risks are not additive. Given the present state of knowledge, however, one all-encompassing standard for banking risks that takes account their interdependencies, still seems far away. As the trend thus far has been towards the development of separate models for the major quantifiable risks, a system of capital standards together with a supervisory review of other, non-quantifiable risks, seems more likely.

Conclusion

15. Let me conclude. The overall issue of this conference, particularly of this session, is where capital regulation is heading. In my address, I have argued that, as supervisory objectives are unchanged, a reduction in banks' capital adequacy would not be desirable. Neither is there a cause for fundamental alterations in the basic framework of the Capital Accord. At the same time, the Basle Committee is committed to maintaining the effectiveness of capital regulation and willing to consider improvements, where possible. In this regard, the advances made by market participants in measuring and modelling of credit and other risks are potentially significant and might at some point be incorporated into capital regulation. But before we reach that stage, there are still formidable obstacles to be overcome.