

Mr. McDonough's address on the occasion of the 10th International Conference of Banking Supervisors Keynote address by Mr. William J. McDonough, President of the Federal Reserve Bank of New York and Chairman of the Basle Committee on Banking Supervision, on the occasion of the 10th International Conference of Banking Supervisors held in Sydney on 22/10/98.

I am very honored to be here as Chairman of the Basle Committee on Banking Supervision and as the Chairman of this year's International Conference of Banking Supervisors. These are unusually difficult and challenging times for bank supervisors around the globe. Turbulence in the financial markets has touched the banking system in virtually every country. To varying degrees and in many different contexts, bank supervisors are dealing with adjustments to their banking systems to assure their strength and vitality.

At times like these, bank supervisors have a special role in maintaining financial stability. That role is to facilitate a resolution of banking problems so that the depository institutions will continue to provide the vital lifeline of credit to businesses and consumers. Past experience in many countries suggests that even severe problems can be overcome with decisive action by banks to identify problems quickly, recognize losses, strengthen the capital base, and execute a sound, forward-looking business strategy.

Today, the supervisory community has the same challenge. We must identify the lessons to be learned from the current financial turmoil and address them. Moreover, we must do so even while there is continued rapid evolution of financial markets, products and strategies and the constant challenge that evolution poses to our existing supervisory policies and techniques. While the challenge of evolutionary financial markets is clear in countries with financial institutions which are actively involved in the international marketplace, it is no less important for emerging market countries, which increasingly feel the influence of international financial competition.

Thus, it is appropriate that we are devoting a day to questions of operational risk, an area of rapid evolution in risk management concepts and practice. The most important current operational risk problem, that of preparing for the century date change in the Year 2000, has a prominent place on the program and in our national supervisory agendas. I congratulate our hosts, the Reserve Bank of Australia, working in cooperation with the Australian Prudential Regulatory Authority, for putting together this program and I thank them for hosting the ICBS this year.

I would like to focus on the dual role of supervisors in preventing banking problems and in providing the necessary support when there are systemic problems. When the Basle Committee, in concert with banking supervisors from around the globe, developed and in 1997 finalized the Core Principles for Effective Banking Supervision, it was with this dual role of supervisors in mind. On the prevention side, our primary goal as supervisors should be to reduce the risk of severe problems to the lowest possible level consistent with adequate provision of credit to the economy and a sense of two-way risk for banking institutions. Quite correctly, most of the Core Principles are aimed at the task of reducing the potential for systemic problems. However, it also is vitally important that when problems arise for an individual institution or a group of institutions, supervisors can provide guidance and supervisory action, as necessary, to resolve the situation. Thus, some Core Principles, especially those on supervisory enforcement and the safety net, address the operational role of supervisors and the institutional context in which they carry out that role.

All of us have learned a lot about marketplace turmoil and systemic risk in the last year to 18 months. First, I will highlight some issues reflecting the close linkages between credit, liquidity and capital adequacy, both at the financial firm and the market level. Next, I will turn to lessons from earlier experiences with banking problems and show how prompt, but deliberate,

responses to credit problems can improve the health and liquidity of the banking system. I will conclude by talking about the work of the Basle Committee, both with respect to the immediate problems and the future agenda.

II. Preventing Financial Problems

The market disturbances of the past 18 months have focused a great deal of attention on the need for greater transparency and for increased attention to corporate governance, legal and accounting matters, without diminishing the traditional supervisory focus on credit, liquidity and capital.

Recent events suggest that we are seeing new ways in which the links between credit and liquidity are increased in the financial system. Wider credit spreads in virtually all actively traded financial markets, accompanied by declines in liquidity in many markets, signal us that credit concerns are rising in the financial system. We, as supervisors, must interpret and respond to those signals, often in shorter time frames than we are comfortable with, and often in concert with a high level of market volatility. One anomaly is that these issues arise in the face of apparently genuine improvements in liquidity in the high-yield bond, syndicated loan, and emerging markets that we have seen at various times since the early 1990s.

Four questions about the current developments appear to offer well-defined avenues which supervisors can pursue.

First, are current market conditions signaling a loss of confidence in prior credit judgments, perhaps in response to the growing awareness of how capital markets instruments, especially derivatives, can transform the risk profile of customers and counterparties?

Second, are growing capital market activities involving credit risk, such as equity and corporate debt underwriting, foreign exchange and credit derivatives, and securitization creating new liquidity stresses, in particular, greater liquidity risk for financial institutions and their customers, when credit quality declines?

Third, to what extent are markets signaling greater uncertainty about the nature and level of risks in the world economy given the tremendous structural change in the world financial system and the world economy over the last two decades?

Fourth, what do recent market developments tell us about the capacity of financial firms to define and manage risk, or to fully understand their own risk profile?

The question of what current market conditions may be signaling about confidence in prior credit judgments is especially important for supervisors. For example, do supervisors need to revise what they expect banks to know about their customers, their business strategies and the business purpose of their transactions? In the run-up to the recent market problems, we have seen customers make use of innovations in financial products and strategies developed since the mid-1980s to a much greater extent than before. For example, banks, corporations and governments in the emerging markets world are far more involved in foreign currency funding, derivatives markets and use of the international capital markets for debt issuance than before. New groups of institutional customers, such as hedge funds, are devoted almost exclusively to developing and executing strategies based on innovative financial instruments and techniques.

The basic financial analysis that is the foundation of the credit process may be affected by changes in both customer and counterparty behavior. For example, a lesson we have learned from the current turmoil is how complex the concept of leverage is in today's markets, where leverage roughly describes the ratio of risk to capital. Where leverage once could be measured directly from the balance sheet, we've become aware that leverage can be achieved in a number of ways. These include holding a high-risk portfolio of assets, engaging in extensive derivatives trading, especially if it involves options, funding domestic currency assets with foreign currency liabilities, investing in long-term assets with short-dated funding and pursuing a high-risk business strategy. All of these effectively can create leverage.

A related lesson learned is that collateral can mitigate credit risk, but it cannot eliminate it. One reason is that posted collateral inevitably lags movements in market prices and recognition of credit issues. In trading agreements, for example, gaps between the amount owed by the customer and the amount of collateral pledged develop surprisingly quickly. One costly solution is to hold large amounts of excess collateral, but that is most often unacceptable to the counterparty. Similarly, when the collateral is real estate, equities or high-yield securities, a gap can open up between the amount owed and the value of the collateral whenever the price of the collateral declines. We have seen both problems in the current turmoil.

These questions of credit analysis and risk control are an integral part of the current work of the Basle Committee on credit risk management. The starting point for that work is a paper describing the framework for traditional credit risk management by banks. That framework can then be used to consider how changes in the financial markets affect the credit process. In addition to the issues I've described, this work will look at the impact of other developments such as credit risk models, credit derivatives and securitization. One goal of this work is to identify areas of risk management which are improving, and those which may need strengthening, especially potential problems in the internal controls that prevent and detect breakdowns in risk control.

The second question, how the larger role of capital markets activities is affecting liquidity risk, also involves a reconsideration of the guidance the Basle Committee developed a decade ago. The recent market turmoil has been especially hard on emerging market banks which funded domestic currency assets with unhedged foreign currency liabilities. The liquidity risk of concentrations on the asset side of the balance sheet has a different significance when assets are sold not only to raise cash but also to conduct portfolio management, which assumes generally liquid markets. Moreover, we are seeing new liquidity needs arising from the changed funding practices of customers. For example, we are seeing instances of customers who had funded themselves largely in the capital markets in recent years turning to the banking system for funding in the current, stressful environment. These observations and issues, which also have been made by others, most recently the Willard Group, have led us to add liquidity management to the near-term agenda of the Basle Committee.

The third question involved the role that uncertainty as a result of structural change in the financial system may be playing in recent market developments. One lesson from this turmoil is how difficult it is to understand the linkages between markets and economies in light of the changing patterns of financial and economic flows.

In the near term, this points to the need to incorporate more guidance on meaningful stress testing into our supervisory policies and devote more attention to it in our supervisory practice. For meaningful stress testing, a bank must have strong information systems that can both aggregate

information about the bank's positions and facilitate analysis of the positions under different scenarios. Better management information systems is one of the primary benefits of the move toward greater modeling of market and credit risk management. Management information systems, however, are not enough. It also is necessary for management to assess the internal and external factors that create risk in relation to the bank's positions in order to come up with revealing stress scenarios. And finally, a bank needs a process to ensure that the results of stress tests receive the high-level attention necessary for the bank to respond effectively to the results.

In the near term, supervisors also must re-examine how they think about concentrations. One lesson from the recent turmoil is how correlations in market prices arise from previously unsuspected linkages: countries with similar government debt structures or similar exchange rate regimes, institutional investors with similar risk strategies, and instruments traded with widely different customers, but with a common element of market risk, such as a country-related risk. Stress testing also can be useful in identifying such concentrations, particularly when accompanied by thoughtful analysis from bank management.

These issues will be addressed in the ongoing work of the Committee on credit and liquidity risk management. In two other areas, we have begun work, but the magnitude of the efforts will involve more time.

The first area is capital. The added focus on stress testing by banks and by supervisors should also influence how supervisors evaluate capital adequacy at banks. As banks are developing risk management and stress testing approaches, some are beginning to look at how they determine whether their capital is adequate to absorb losses, including losses under reasonable stress scenarios. One lesson from the current environment is the enormous size of market movements that are possible in such a stress scenario—whether in currency or equity markets or in credit spreads, and how quickly losses from even small positions can mount. As banks develop new methods of evaluating capital adequacy, we can consider whether these approaches provide new tools for assessing capital adequacy from a supervisory perspective.

The second area is transparency. The challenge of understanding the impact of changes in the financial system on banks and financial markets should add impetus to our efforts to increase transparency in the financial markets. As understanding the nature of the borrower and its risks becomes more complex, the demand for better and more timely information is increasing. Moreover, we supervisors have a special interest in putting good information in the hands of investors, lenders and counterparties, and that is the powerful assistance that market discipline can provide supervisors. We have seen how a bank's equity price, its funding spreads and its access to markets can provide feedback on the bank's prospects, and how these market signals can be a decisive factor in motivating management to address problems. We also have seen through current events how the absence of sufficient information can mask critical weakness in the corporate and banking sectors, leading initially to an over-optimism that is followed by excessive risk aversion.

The Basle Committee has created two working groups, the Transparency Subgroup, led by Susan Krause of the Office of the Comptroller of the Currency, and the Accounting Task Force, led by Nick LePan, of the Office of Supervision of Financial Institutions in Canada, to suggest ways in which banks, bank supervisors, the accounting community and others can further transparency.

I have described several issues and spoken mainly about areas for additional supervisory guidance. But as we consider the issues of credit, liquidity and capital raised by recent

market developments, we should look at the full range of tools that supervisors have at their disposal to help prevent financial problems. They include:

licensing, which ensures that banks are owned and managed by people with integrity and appropriate expertise and that activities they engage in are limited to those deemed appropriate for banks;

prudential regulation, which sets standards to ensure the prudent operation of banks;

best-practice guidance, which allows banks to benefit from the supervisor's knowledge of superior industry practices;

on and off-site supervision, which allows supervisors to review banks' operations, procedures and records for the purpose of evaluating compliance with laws, prudential standards and other safe and sound banking practices, as well as to gauge the risk inherent in banks' entire operations;

accounting and disclosure standards, which ensure that investors have an accurate picture of banks' financial condition; and

enforcement powers, which allow supervisors to take action to correct violations, address overly risky practices and resolve problem situations.

III. Resolving Financial Problems

The immediate problem for many banking supervisors is to address the problems of credit, liquidity and capital adequacy in their national banking systems. Banking supervisors have an important role to play in encouraging a rapid but deliberate recovery of asset quality at banks. While it is still too early to look at lessons learned about resolving such problems from this round of banking difficulties, we can draw on the lessons of the past.

The 1980s and early 1990s offer examples of what can be done to resolve banking problems. For example, the United States suffered oil and agriculture-related regional recessions in the 1980s and a real-estate and leveraged buyout-led recession in the early 1990s. Severe real-estate-related problems developed around the same time in many European countries, with serious repercussions for some banking systems. Today, banks in most of these countries are much stronger, and until recently, highly profitable. What happened?

I would like to suggest five steps that form a common theme in the more successful recoveries. First, banks, often with the assistance of their supervisors, ascertained the true dimensions of their credit problems. The result of the process was realistic assessments of:

a total of actual losses in the portfolio that needed to be charged off;

the potential additional losses, both in a "most likely" and "worst case" scenario; and

the exposures that needed to be considered in "workout" mode. The workout loans were those which had sufficiently severe problems that it was time to stop viewing them as "business as usual", but to see them as requiring special attention.

Second, the workout loans or exposures were assigned to the special expertise of workout specialists. Banks built their own staffs or outsourced the activity to another financial institution, a consulting firm or a boutique. In the early 1990s, some banks took an even more drastic step and sold the loans to firms that specialized in managing distressed debt. The key, however, was to get these exposures in the hands of those who could work with borrowers or the markets to maximize the value from problem portfolios.

The workout process must not be allowed to interfere with the continued provision of credit to the economy, however. The key policy concern in the early 1990s in the United States shifted quickly from worries about bad banks to a credit crunch as banks aggressively tackled their loan problems. And that is why it is so important to segregate the “workout” portfolio from the remaining loan portfolio. When a dedicated staff is working out bad loans, the bank’s officers can devote their attention to the continued sound operation of the bank—the current agenda of serving the bank’s customers well and the forward agenda of developing and executing a sound business strategy.

This is a key reason every country needs a strong legal framework for credit relationships and a robust bankruptcy process. Successful workouts cannot occur if the roles and responsibilities of creditor and debtor are not clear, and especially if there are no established processes that can be used as a fallback and discipline on debtors if all other means of recovery are exhausted.

Third, the banks assessed the consequence of identified and potential losses on their loan loss reserves. The Basle Committee has just this month published guidance on the valuation of loans and loan loss provisioning. It urges that loan impairment be recognized promptly, that loan loss reserves reflect the potential for loss in the credit portfolio, and that adequate disclosure about credit quality, loan loss provisioning and loans losses be made.

Fourth, banks, often with the help of supervisors, assessed the adequacy of their current and prospective capital levels in light of the loan losses identified and the loan loss potential estimates reflected in the reserves. In most cases, this meant a need for additional capital, whether by raising capital funds directly from the market or from existing shareholders, or by considering a merger or sale of all or some of the bank.

This issue of raising capital when the bank is under stress is one of the most difficult questions for bank management and for supervisors, but our collective experience suggests that solutions can be found even in very difficult markets. The key to success appears to be a clear disclosure of the existing problems, an action plan to address the problem, and a viable business strategy going forward. We know from experience that when a bank takes these steps, current and potential investors are far more likely to react positively. Indeed, there is a well-developed community of investors seeking bargains among distressed institutions with decent prospects for recovery.

When banks turned to shareholders or the marketplace to raise new capital, they often were confronted with concerns about market perception, dilution of existing shareholders, potential loss of control by the current owners, and reduction of prices of existing equity and debt. These were and are valid issues, but again, judging from experience, they proved to be secondary to the central issue of ultimate recovery or resolution of the bank.

The enlightened self-interest of the management of a troubled bank usually allows it to see what needs to be done and to take appropriate action. If not, supervisors must have the means to step up the pressure through statutory enforcement powers. While the pressure initially can be informal and private, in the form of supervisory letters or similar instruments, it must be possible to move to more formal types of agreements with the board of directors of a troubled banking institution.

Fifth, bank management and supervisors resolved troubled banking institutions. In the first instance, this meant understanding and helping bank boards of directors to understand what the options were for realizing value from the institution. Even for a bank losing substantial amounts of money, there may be aspects that represent valuable customer franchises or the opportunity to enter a new market or the ability to consolidate operations and increase operating leverage. These are assets for which there is a market—and a market price. Realizing the value from these assets while winding down the less viable aspects of the business may be one way for the bank itself to manage its own market exit.

As a second line of approach, banking supervisors had resolution procedures and the necessary statutory powers to take over failing banks and resolve them. This almost always involved the need for additional capital and funding. In many cases, the banking agency or deposit insurer could sell off deposits and other elements of the franchise in such a way that continuous service could be offered to customers. Since the banking agency or insurer often was left with the bad assets, workout expertise was required to realize value from them.

Throughout these steps, supervisors need to work with troubled banks in a constructive manner, just as banks should deal with troubled customers. If the supervisory process is too harsh, the supervisor will exacerbate the stresses on credit and liquidity in the financial system. Bank supervisors must have the tools and the determination to make steady progress in terms of recovery or to seek resolution through merger, sale or the winddown of the bank. The process of workout may be deliberate and patient, but it must move forward as quickly as practicable and not be permitted to stall. Only then can the normal flow of credit and liquidity in the financial system be maintained.

Finally, it is important throughout the process of restructuring a banking system that the general public does not have to fear for the loss of their life savings. A reliably funded deposit insurance mechanism, a central bank that can provide liquidity to solvent, viable banks and a well-functioning payments system are essential elements of the public sector safety net. The safety net's true beneficiaries are not financial institutions, but the general public.

IV. The Role of the Basle Committee

What do I see as the near and medium-term role of the Basle Committee and this organization of banking supervisors? What should be our goals to meet before the next such conference, to take place in New York in the Year 2000?

Let me begin by saying that the Core Principles lay out the major highway to effective banking supervision, but do not provide a detailed street plan. One important element of feedback we are receiving from the Core Principles Liaison Group, consisting of members of the Basle Committee and members of the emerging markets, along with more informal feedback, is the need to provide more detailed street plans. There are several ways to achieve that.

The first is to continue to elaborate on the Core Principles by producing papers on key topics to augment and update the Compendium. The Compendium is the set of relevant papers issued over the years by the Basle Committee which elaborate further on the Core Principles and provide the next level of detail. In the past year, for example, we have published papers on internal control systems for banks, interest rate risk management and operational risk that fill in some of the gaps in the Compendium related to risk management and internal controls. These were prepared by the Risk Management Subgroup, chaired by Roger Cole of the Federal Reserve Board and Christine Cumming of the Federal Reserve Bank of New York. We have work underway now in that Subgroup for future papers on supervisory issues in credit risk management, corporate governance and internal audit.

As another example, we issued a paper on the framework for enhancing transparency last month. The Transparency Subgroup intends to build upon that framework, with special emphasis on trading, derivatives and credit risk disclosure. In addition, as noted, we published last week a paper on loan valuation and loss reserves.

This probably is still not enough detail for many supervisors. The need for more detail may be better met through increased technical assistance provided by the Basle Committee on Banking Supervision, along with similar assistance programs of its individual members. Moreover, the International Monetary Fund, the World Bank, and regional development banks have stepped up their efforts to provide technical support as well. Often, the detailed street plan can be developed only with very specific knowledge of the marketplaces, banks' powers and roles in the financial system, and the laws and regulations of the country in question. Local supervisors and outside technical experts can work together to fashion specific supervisory guidance and regulation that are appropriate in the local marketplace.

Additional resources are available from the Institute on Financial Stability, a joint effort of the G-10 central bank governors, the Basle Committee, the International Organization of Securities Commissions (known as IOSCO) and the International Association of Insurance Supervisors (known as IAIS). The purpose of the Institute is to provide training to senior supervisors and other supervisory staff in the application of basic supervisory principles to their national supervisory systems. The job of senior supervisors in the emerging markets is an immensely challenging one, requiring negotiation, management and leadership skills, in addition to technical supervisory skills. The Institute, by bringing together key policy-making officials in central banks and supervisory agencies through high-level seminars, serves the dual purpose of sharing expertise and developing and deepening the relationships among supervisors globally. The Institute will hold courses not only in Basle, but on a regional basis as well. The Institute will act as a clearing house for the coordination and provision of technical assistance by central banks and supervisory bodies.

We also must work closely with the IMF and the World Bank. These institutions put people in virtually all of the world's countries to evaluate candidly the macroeconomic and financial climate and supervisory policies and practices. In an important development for the furtherance of the Core Principles, the IMF and World Bank are using the Core Principles as the benchmark for evaluating supervisory regimes around the world.

This is an effort that the Basle Committee plans to support not only through continued work on the Core Principles and the Compendium, but by providing expertise and supervisory resources to supplement and advise IMF and World Bank staff. The members of the Basle Committee in many cases have the staff with the deep expertise to help emerging markets supervisors with the application of the Principles in their national context and in light of various

obstacles. The IMF and World Bank have expressed their desire to bring more of that expertise to bear in their efforts, and we have begun discussions on how to accomplish that most effectively. In addition, we believe that first-hand observation of the practical issues in implementation will suggest what further elaboration and precision would be most useful to the Core Principles, and what additional research and papers, programs by the Institute for Financial Stability or specific technical assistance could supplement them. Our goal is to keep the Core Principles relevant, incisive and implemented by supervisors globally.

In addition, we in the broader financial supervisory community must set thoughtful goals for ourselves as we manage our individual agendas. The problems that have beset many countries in Asia, Russia and other regions and countries are not confined to the banking sector, although that may be the largest part of the financial sector. Together with IOSCO and the IAIS, we should work to strengthen internal financial firm management, supervision and market discipline, no matter what the nature of the financial firm or market.

As a final point, let me stress that while we continue to elaborate the roadmap of the Core Principles, we must also press on in understanding the frontiers of financial developments. This makes for a difficult and ambitious agenda, but we must be and we are up to the challenge.

The most important example of this broad effort is the work the Committee has begun on the future of capital. We know the value the Basle Accord has had in strengthening capital standards around the world. At the same time, we have recognized that advances in risk management and financial practices are beginning to erode the relevance of the Accord for the most technically sophisticated banks. That means that we must identify ways to ensure that the Accord will provide meaningful guidance for the maintenance of strong capital levels at those banks, while still providing the fundamental protection to the financial system that is needed in all countries.

To that end, the Committee has formed a Steering Group on the Future of Capital, chaired by Claes Norgren of the Swedish Financial Supervisory Authority. It is my hope that the review conducted by the Steering Group will bring together new thinking on a minimum capital rule, a comprehensive look at the supervisory evaluation of capital adequacy, which I described earlier, and enhancements to market discipline.

On this issue, as on all the others we have discussed this morning, we in the Basle Committee must work and will be working closely with supervisors around the world. To that end, we hope to work with the Core Principles Liaison Group, and the much broader Core Principles Consultation Group, which met earlier this week. One of our goals in 1999 is to enhance further the utility and the dialogue in those Groups, to ensure that we are jointly building the supervisory framework for the 21st century.