Mr McDonough discusses the changing nature of banking, risk and capital regulation

Speech by the President of the Federal Reserve Bank of New York, Mr William J McDonough, at the 29th Annual Banking Symposium, Bank and Financial Analysts Association, New York City, on 17 March 1999.

Good afternoon. I am pleased to be here today to discuss the changing nature of banking, risk and capital regulation. With the new millennium on the horizon, it seems a particularly fitting time to discuss some of the key trends that are affecting the way both bankers and supervisors think about these issues. Also, as I'm sure many of you are aware, the Basle Committee on Banking Supervision currently is engaged in a fundamental review of the Accord, which is the cornerstone of existing capital standards. In many ways, the changing nature of banking and its risks have led supervisors to revisit the current capital framework, and so I welcome this opportunity to provide my perspective on these risks and how they relate to the future of capital regulation more generally.

In the last several years, we have witnessed an increase in the diversity and complexity of businesses in which banks are engaged. While lending and deposit-taking are still the mainstays for a majority of commercial banks, many banks have grown their derivatives trading, securities underwriting and corporate advisory businesses. Some banks have expanded their traditional credit product lines to include asset securitizations and credit derivatives. Still other banks have greatly increased their transaction processing, custody or asset management businesses, in the pursuit of fee income.

Looking forward to the next century, I believe we will see major strides in the area that I suggest we call "e-finance". More banks will venture into the relatively new world of on-line PC banking or will expand electronic bill presentment and paying services. Banks will be motivated to overcome obstacles such as systems incompatibility and consumer privacy concerns, to achieve greater operating efficiencies and to protect their valuable payments franchise. Going forward, on-line purchases and sales of securities by individuals also will continue to increase, producing a growing source of commissions for financial institutions.

For most banks, these developments will mean a further increase in the diversity and complexity of risks to which they are exposed, including, but not limited to, credit, market and operational risks. The challenge for these banks will be to develop risk management systems that are rigorous and comprehensive, yet flexible enough to address the newer risks they take on as they expand into less familiar product areas. Today, I would like to highlight these risks and focus on how important it is for banks to integrate their risk management and capital planning processes. Also, I would like to focus on how the changing nature of banking is challenging supervisors to rethink their approach to capital regulation and supervision.

Despite changes in banking over the last few years, many of which already have been discussed today, credit risk remains the predominant risk for most banks. However, credit risk clearly extends beyond conventional credit products such as loans and letters of credit. Today, banks are taking on credit risk in the form of margin lending and transactions in the over-the-counter derivatives markets that expose them to large amounts of counterparty risk and can be difficult to measure. They also may be engaged in taking on credit risk in its more subtle forms. The short-term credit risks in futures brokerage, where the clearing broker stands between the customer and the exchange, or the often underestimated, but substantial, credit

risks that arise in settling foreign exchange contracts, are examples. Credit risk also may exist in more complicated, less conventional forms, such as credit derivatives or tranches of securitized assets.

Market risk also remains prominent. The upheavals in both global fixed income and equities markets over the last year led to a great deal of volatility in spreads and asset prices and caused large swings in bank profitability. These events demonstrate that the world doesn't necessarily work the way we thought it did, that there are correlations between markets that we had previously thought were unrelated. As banks continue to expand their global trading operations, the need to understand the relationships between markets increases. This challenge is amplified by technological advances and financial product innovations that contribute to ever-more complex market instruments.

But clearly, banks are exposed to more than just credit and market risk. Operational risk also is a growing concern for the banking industry. The looming issue of Year 2000 remediation is just one example. With the continuing diversification of banking, the fast pace of financial innovation and the growing concentration of crucial payments, settlements and custody businesses, the importance of operational risk is rising, especially at many larger institutions. These institutions find that the probability of a financial loss resulting from a breakdown in internal controls or systems is greater than ever. As banks expand into new lines of business, such as electronic banking, this trend is likely to continue. For instance, consider the risk of a breach in electronic security controls that leads to unauthorized access to confidential customer information. Should this breach be severe and pervasive, it could lead to considerable legal and reputational problems for a bank. Further, the overall rapid pace of technological change in this area means there is a substantial risk of obsolescence.

These are just some of the risks that banks must manage, and clearly the list I have set forth is not exhaustive. In particular, consider banks in emerging market countries that are subject to a unique set of risks as a result of the financing and investment cycles in their countries. Those banks that fund their domestic assets with foreign currencies may be particularly susceptible to liquidity risk when sharp fluctuations in exchange rates and market turbulence make it difficult to retain sources of financing.

While I have presented to you some of the major risks as separate and discrete, we recently have discovered that they are, in fact, inter-related. For instance, we have seen that market risk frequently drives credit risk. In the second half of last year, we saw turbulence in fixed-income markets produce severe liquidity and solvency risks for hedge fund market participants. Also, we have learned that credit risk may derive from operational risks, embedded in complex systems for managing collateral or intra-day funding, both of which require rigorous internal control environments.

Regardless of the nature or form of risk, the best way for all banks to protect themselves is to identify risk correctly, accurately measure and price it, appropriately control it and maintain high levels of reserves and capital, in both good times and bad. However, many banks are not finding it easy to develop a holistic approach to assessing and managing the many inter-related risks they face. A particular challenge is to relate such risk assessments to appropriate capital levels, especially given the dynamic nature of their businesses.

Before I discuss how some banks are tackling this issue, let me first consider the role of capital more generally and how it relates to risk and strategy.

Fundamentally, the role of capital is to act as a buffer against unidentified, even relatively remote losses that a bank may incur in the future. A bank must hold enough capital to cushion both depositors and senior lenders against losses, while leaving the bank able to meet the needs of its customers. Banks must maintain capital commensurate with the amount of risks that they take and hold enough to weather financial storms, which can at times be severe and of considerable duration. Banks with low equity capital ratios and a high variability of operating earnings have proven particularly vulnerable to financial distress.

However, banks do not just hold capital to overcome distress, but also because it provides them with financial flexibility. Banks that are strongly capitalized can take advantage of growth opportunities. Also, strongly capitalized banks are better able to promote innovation, whether in the form of new products, new services or new distribution channels. This is not just a capital resource issue, but a human resource issue. Bank managers who are able to focus on the business of banking, strategy and competition, rather than on financial difficulties, can create and innovate and, therefore, add value for shareholders.

Banks also hold capital as a sign of strength to their customers. Clearly we know this to be true with depositors on the retail side, but it is equally true on the wholesale side. When an institution or corporation enters into letter of credit guarantees or swap contracts, it needs to be confident that its bank will be around in three or five years, at the maturity of the contract. A bank that is well capitalized can credibly state to its customers and clients that it can make good on its promise to pay. More and more, clients recognize this and differentiate among various banks on this basis. As financial services converge and competitive pressures increase, banks find that they must vie for capital, not only with their domestic and foreign counterparts, but also with investment funds, asset management firms, investment banks and insurance companies.

This is equally true for emerging market banks that find they must compete with internationally active banks in what were previously thought to be solely domestic markets. These banks recognize that an adequately capitalized institution is a necessary, but not sufficient, condition to compete globally and to attract international funds and clients. It will be a challenge for these banks, and particularly those with high-risk profiles and opaque financial statements, to prove to clients, counterparties and stakeholders that they are operating safely and soundly.

In the face of increasing competitive pressures, banks are focusing more of their attention on the role of capital, capital levels and targets, and how they relate to strategic plans and objectives. Many banks also are spending more time assessing their own risk profiles and evaluating the amount of capital they need to cope with adverse outcomes in normal times and under reasonable stress scenarios. The more sophisticated banks are in the process of developing internal systems and methodologies, including formal analytical models, that enable them to do this better. Some of these banks rely on capital allocation methodologies typically used for pricing and performance measurement across business and product lines as a basis for their analysis. These methodologies frequently incorporate different kinds of volatility-based measures that include a view of unexpected loss, along with more subjective measures of risk. While many of these systems and methodologies are still in their early stages

and require refinement, I am encouraged by their development, and hope that the assessment of capital adequacy will continue to be a primary focus of risk management at banking institutions.

The senior management of banks can take this further by evaluating not only the adequacy of their current capital levels, but also the appropriateness of their capital structure. Ideally, this analysis would lead to a process that integrates decisions about business strategy, risk profile and future capital needs.

As banks become better at identifying and quantifying their risks, they should be well positioned to enhance risk disclosures and inform investors more fully. While bank investors ultimately bear the risks of the institution, too frequently they are not in a good position to make knowledgeable business decisions about a bank's prospects. Certainly, investors are less well informed than bank management. In many countries, accounting and disclosure standards do not provide users of financial statements with the necessary information to appropriately assess risks and determine soundness. A lack of transparency discourages capital from flowing efficiently and, in effect, reduces or even destroys value.

However, on a positive note, I am encouraged by progress in numerous countries to promote disclosure and transparency, for instance with regard to non-performing loans. The Basle Committee on Banking Supervision, the Committee on the Global Financial System, the International Accounting Standards Committee and other organizations have put forth initiatives to enhance the relevance, reliability and comparability of information disclosed by the financial sector. The most important initiatives will be those of national governments to apply these accounting and transparency frameworks, as well as the voluntary disclosures of financial institutions.

Now that I have discussed the changing risk environment and how banks are responding to that challenge, let me turn to what this means for the current regulatory capital regime.

Today, a major challenge for regulators is to develop capital standards that address more comprehensively the full range of risks to which banking institutions are exposed. These standards must also improve the differentiation among high-risk and low-risk exposures and between weak and strong institutions. Additionally, they must be flexible enough to accommodate the risks of newer and emerging activities, some that I have mentioned today.

As you know, the primary tool of capital regulation currently is the set of minimum capital ratios that were devised in 1988 by the Basle Committee on Banking Supervision. They were set forth in an agreement known as the Basle Accord, and were adopted, among other reasons, to address the slide in international capital levels that was occurring over a decade ago. While these ratios were relatively basic, they have proved very effective at achieving their goal over the last decade.

Over the years, risk management approaches have evolved rapidly, while the Basle Accord has evolved relatively slowly. As market risk management techniques developed, we were able to incorporate a state-of-the-art value-at-risk approach, in a 1996 Market Risk Amendment. As credit risk management techniques have advanced, and as a new discipline of operational risk has emerged, it has become apparent that the long-run relevance and efficacy of the Basle Accord is waning for the most sophisticated institutions.

Supervisors have long known that analyzing simple capital ratios in isolation can lead to incorrect conclusions about the relative strengths of institutions. Thus, they also have relied on a review of banks' capital plans and on market discipline to assess bank capital adequacy. As we go forward, banking supervisors are building a capital framework on these three pillars – capital supervision, capital regulation and market discipline – and we look to strengthen each of them.

Let me start with capital supervision. The cornerstone of supervisory review is the bank's process for assessing its overall capital adequacy in relation to its risk profile and its strategy for capital level and structure. Supervisors believe they should review and evaluate bank-internal capital adequacy assessments and strategies, in addition to bank compliance with regulatory capital ratios. The better the bank's own capital adequacy assessment, the better the supervisor will understand the bank's capital strategy. Inevitably, this aspect takes on greater importance. For one reason, supervisors expect banks to operate above minimum regulatory capital ratios included in the Basle Accord – and prudent assessments can help to inform by how much. For another, supervisors seek to intervene early enough to prevent capital from falling below prudent levels – and bank assessments can provide another useful tool in identifying key issues before they become major problems. With these thoughts in mind, supervisors are tackling the challenge of developing a more systematic approach to the review of capital adequacy.

Supervisors also are discussing ways to enhance market-based discipline. Most agree there should be a greater role for private-sector monitoring of banks. Of course, there already exists a fair amount of market-based monitoring; however, the collection and use of these kinds of information usually are not systematic or complete. The first goal is to improve information available to the market. With enhanced risk disclosure, supervisors will be more able to rely on the opinion of market investors. These opinions are reflected quickly in the price of bank debt and share prices, and the ease with which banks can access capital. By relying more on these market signals, supervisors will be better able to identify and address waning capital levels at problem institutions.

To the extent banks develop disciplined internal approaches to evaluating capital adequacy and capital plans, and enhance disclosures, supervisors will be able to place greater reliance on all three pillars and meet the challenges of a more complex financial marketplace. The common interest is to keep the Basle standards at a level sufficient to ensure financial soundness, a minimum above which banks will choose to operate. To achieve this, we must fashion a set of standards that does not greatly distort incentives.

Supervisors acknowledge that the current regulations and ratios need to be updated to be more meaningful, given the full range of risks banks face today. Supervisors are always challenged to keep pace with financial innovation and improvements in risk management practices, and this suggests that we will need a frequent monitoring and maintenance program for the present and future Accord.

In closing, I would like to summarize the key supervisory objectives that we are mindful of as we look to revise the Accord and enhance the overall capital framework. Our first objective, of course, is to promote the safety and soundness of the financial system. Our second is to enhance competitive equality, while allowing for differences among banks based on

differences in their risk profiles. These were the original goals of the Accord. Our third is to develop standards that are fundamentally applicable to banks of varying levels of complexity and sophistication, including those in emerging market nations.

In developing this capital framework over the next year, we plan to consult closely with the financial and supervisory community and communicate openly about our progress. By year-end, we hope to have made great strides in furthering our objectives. Clearly, beyond 2000, a sound capital framework will help to ensure that banks are well positioned to face the challenges and exciting opportunities that the new millennium has to offer.