Mr Greenspan looks at the evolution of bank supervision

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the American Bankers Association, Phoenix, Arizona on 11 October 1999.

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I appreciate once again being invited to participate in your annual convention. The convention theme, “Creating Sustainable Competitive Advantage,” is well chosen for an industry that continues to be characterized by dramatic change.

This morning I should like to address one aspect of response to change – the evolution of bank supervision.

As the theme of your convention suggests, the economic landscape is continually evolving. To remain competitive, individual banks must adapt, and they have. It is no less natural to expect that supervisory policies and practices also would evolve and adapt over time. Banking supervision is responding, though admittedly not as rapidly as the industry itself. This is not necessarily all bad. The physician’s admonition “First do no harm” is a desirable starting point for bank supervisors as well.

Nevertheless, significant changes are in the pipeline. Today I would like to sketch the framework that is now being developed, growing out of work at the Federal Reserve, at other US banking agencies, and by our colleagues abroad. The outline of this framework was presented in a consultative document released by the Basel Supervisors Committee in June. The details are preliminary, but the concepts are beginning to congeal and deserve your close attention, especially if you wish to influence the eventual outcome of the deliberations.

The first concept I would highlight is that the scope and complexity of prudential policies should conform to the scope and complexity of the bank entities to which they are applied. This means, in practice, that few changes to the present system are necessary for the vast majority of banks in the United States. More broadly, however, a one-size-fits-all approach to regulation and supervision is inefficient and, frankly, untenable in a world in which banks vary dramatically in terms of size, business mix, and appetite for risk. Even among the largest banks, no two institutions have exactly the same risk profiles, risk controls, or organizational and management structure. Accordingly, prudential policies need to be customized for each institution: the more complex an institution’s business activities, the more sophisticated must be our approach to prudential oversight.

The need for a multi-track approach to prudential oversight is particularly evident as we face the reality that the megabanks being formed by growth and consolidation are increasingly complex entities that create the potential for unusually large systemic risks in the national and international economy should they fail. No central bank can fulfill its ultimate responsibilities without endeavoring to ensure that the oversight of such entities is consistent with those potential risks. At the same time, policymakers must be sensitive to the tradeoffs between more detailed supervision and regulation, on the one hand, and moral hazard and the smothering of innovation and competitive response, on the other. Heavier supervision and regulation designed to reduce systemic risk would likely lead to the virtual abdication of risk evaluation by creditors of such entities, who could – in such an environment – rely almost totally on the authorities to discipline and protect the bank. The resultant reduction in market discipline would, in turn, increase the risks in the banking system, quite the opposite of what is intended. Such a heavier hand would also blunt the ability of US banks to respond to crisis events. Increased government regulation is inconsistent with a banking system that can respond to the kinds of changes that have characterized recent years, changes that are expected to accelerate in the years ahead.

The desirability of limiting moral hazard, and of minimizing the risks of overly burdensome supervision and regulation, has motivated those of us associated with the Basel exercise to propose a three-pillared approach to prudential oversight. This approach emphasizes, and seeks to strengthen, market discipline, supervision, and minimum capital regulation.

Market discipline

In trying to balance the necessary tradeoffs, and in contemplating the growing complexity of our largest banking organizations, it seems to us that the supervisors have little choice but to try to rely more – not less – on market discipline – augmented by more effective public disclosures – to carry an increasing share of the oversight load. This is, of course, only feasible for those, primarily large, banking organizations that rely on uninsured liabilities in a significant way. To be sure, these organizations already disclose a considerable volume of information to market participants, and, indeed, there is ample evidence that market discipline now plays a role in banking behavior. Nonetheless, the scale and clarity of disclosures is better at some institutions than at others and, on average, could be considerably improved. With more than a third of large-bank assets funded by non-insured liabilities, the potential for oversight through market discipline is significant, and success in this area may well reduce the need to rely on more stringent governmental supervision and regulation.

The channels through which market discipline works are, of course, changes in access to funds and/or changes in risk premia as banks take on or shed risk or engage in certain types of transactions. The changing cost and availability of bank funding affect *ex ante* risk appetites of bank management and serve as market signals of a bank's condition to market participants *and* to examiners. But the prerequisite to the enhancement of market discipline in conjunction with supervision and regulation is improvement in the amount and kind of public disclosure that uninsured claimants need about bank activities and on- and off-balance-sheet assets in order to make informed judgments and to act on those judgments. Information on loans by risk category and information on residual risk retained in securitization are examples. The best way to encourage more disclosures is not yet clear. Our intent is to consult with the industry regarding the establishment of new disclosure standards and ways to evaluate their application.

Supervision

Improved public disclosure will, we believe, not only enhance market discipline but also create further incentives for improvements in banks' risk-management practices and technologies. Such improvements will enhance the supervisory pillar of prudential oversight. If supervisors are comfortable with a bank's internal risk-management processes, the most cost-effective approach to prudential oversight would have supervisors tap into that bank's internal risk assessments and other management information. To be sure, some "transaction testing" of risk-management systems by supervisors will necessarily remain. But as internal systems improve, the basic thrust of the examination process should shift from largely duplicating many activities already conducted within the bank to providing constructive feedback that the bank can use to enhance further the quality of its risk-management systems. It is these internal bank systems – coupled with public disclosure – that provide the first line of defense against undue risk-taking. Indeed, it should be emphasized that the focus of supervision and regulation – especially for the larger institutions – should be even less on detail and more on the overall structure and operation of risk-management systems. That is the most efficient way to address our interest in both the safety and soundness of the banking system and the overall stability of financial markets.

Relying more extensively on banks' internal risk-management systems can also be used to enhance prudential assessments of a bank's capital adequacy. As the Basel consultative document suggests, over time our examination process for assessing bank capital adequacy would try to use the same techniques that banks are, and will be, using to evaluate their risk positions and the capital needed to support these risks. To spur this process in the United States, the Federal Reserve in June issued new examination guidance encouraging the largest and most complex banks to carry out self-assessments of their capital adequacy in relation to objective and quantifiable measures of risk. These self-assessments will be evaluated during on-site examinations and, eventually, are to be a factor in assigning supervisory ratings.

A key component of these self-assessments will be each bank's internal risk evaluations of the credit quality of its customers and counterparties. Currently, such internal risk ratings are beginning to be used by a small number of banks in their risk-management, pricing, internal economic capital allocation, and loan loss reserve determinations. Some banks are further along in the process than others. Virtually all large banks are moving in that direction. The bank regulators already have begun incorporating reviews of these internal risk-rating processes into their on-site examinations, and last July the Federal Reserve issued examination guidance on this subject, including a summary of emerging sound practices in this area.

The supervisory policies and procedures being contemplated will build on the increasingly sophisticated management and control systems that are rapidly becoming part of banks' best practice risk-management mechanisms. They will, as well, require both good judgment and sophistication on the part of bank examiners in order to avoid a cookie-cutter application of policies and to develop skills at evaluation that will match those available to the banks. For each of about thirty large, complex banking organizations – in Washington parlance, LCBOs – the Federal Reserve has already established dedicated teams of examiners, supplemented by experts in areas ranging from clearance and settlement to value-at-risk and credit-risk models. Each LCBO team is directed by a senior Reserve Bank official. Both that "central point of contact" and his or her supervisory team will be charged with following one LCBO and understanding its strategy, controls, and risk profile. Jointly, these teams will represent the Federal Reserve supervisory pillar as it applies to LCBOs.

Minimum capital regulation

In addition to emphasizing more effective market discipline and making supervisory assessments of bank capital adequacy more risk-focused, the June consultative paper highlights the need to make *regulatory* capital requirements – the third pillar of prudential oversight – more risk-focused as well. In recent years, it has become clear that the largely arbitrary treatment of risks within the current Basel Accord has distorted risk-management practices and encouraged massive regulatory capital arbitrage. That is, our rules have induced bank transactions that have the effect of reducing regulatory capital requirements more than they reduce a bank's risk position. Consequently, the fundamental credibility of regulatory capital standards as a tool for prudential oversight and prompt corrective action at the largest banking organizations has been seriously undermined.

In reflection of the considerable differences among banks that I mentioned earlier, US supervisors are developing proposals for a multi-track approach to address modifications to the regulatory capital rules, and this approach has been incorporated in the Basel consultative document. Within the United States, consideration is being given to a standardized capital treatment involving a quite simple regulatory capital ratio that might become applicable to the vast majority of institutions that are not internationally active. For another group of banks, change might involve such modest refinements to current capital requirements as closing certain loopholes and basing some risk-weights on available external credit ratings.

For those comparatively few banking organizations whose scale, complexity and diversity warrant a more sophisticated approach to capital adequacy, the Basel Committee has proposed another track that, at least initially, would seek to link regulatory capital requirements to the banks' internal risk ratings that I discussed earlier. Under this approach, the risk-weight assigned to a particular credit position would be based on the internal risk rating assigned by the bank holding that instrument. Regulatory staffs in the United States and other countries are currently attempting to work out the basic architecture of such an approach. Critical issues include how to validate banks' internal risk ratings and how to link risk-weights to these internal ratings so as to ensure economically meaningful and reasonably consistent capital treatment of similar risks across banks. This is an extremely difficult undertaking, and its success will require unprecedented collaboration between – and among – supervisors and the banking industry.

The framework

It is, I believe, important to reiterate my earlier comment that bank supervision and regulation – especially capital regulation – are necessarily dynamic and evolutionary. We are striving for a framework whose underlying goals and broad strategies can remain relatively fixed, but within which changes in application can be made as both bankers and supervisors learn more, as banking practices change, and as individual banks grow and change their operations and risk-control techniques. Operationally, this means that we should not view innovations in supervision and regulation as one-off events. Rather, the underlying framework needs to be flexible and to embody a workable process by which modest improvements in supervision and regulation at the outset can be adjusted and further enhanced over time as experience and operational feasibility dictate. In particular, we should avoid mechanical or formulaic approaches that, whether intentionally or not, effectively "lock" us into particular technologies long after they become outmoded. We should be planning for the long pull, not developing near-term quick fixes. It is the framework that we must get right. The application might initially be bare-boned but over time become more sophisticated. For example, it could begin with a limited number of risk "buckets" and, over time, be expanded to include not only more risk categories, but also the use of an individual bank's full credit-risk model – all within the same supervisory framework and unique to each bank.

The design of the improved oversight approach is a work in progress. We are endeavoring to develop a program that is the least intrusive, most market based, and most consistent with current and future sound risk-management practices possible, given our responsibilities for financial market stability.