Challenges Facing the International Community of Bank Supervisors

by E. Gerald Corrigan

I am delighted to be here with you in my capacity as Chairman of the Basle Committee on Banking Supervision, and I very much appreciate the extraordinary efforts our French colleagues have made in planning and organizing this conference—efforts that began two full years ago.

These are not the easiest of days for the international community of bank supervisors. Indeed, the challenges and problems we face today are perhaps the most demanding and vexing in the post-World War II period. In these circumstances, it is not at all a simple task to try to frame my remarks this morning. For starters, I will give you an overview of the current work and priorities of the Basle Committee. Taken by itself, however, such an overview runs the risk that we will all better see the trees but still will not have a vision of the forest. Accordingly, I will keep my remarks regarding the current work of the Committee relatively brief in order to devote equal time to some of the larger challenges that face the international community of bank supervisors.

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Turning first to the current work of the Basle Committee, the immediate priorities of the Committee can best be captured in several discrete but not unrelated areas of endeavor. In summary form, they are:

First, partly in response to the Bank of Credit and Commerce International (BCCI) episode, the Committee has recently promulgated "Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments." Since that paper will be the focus of our discussions throughout today's program, I do not intend to go into its details at this time. I do want to stress, however, that from a broad policy perspective, the major thrust of the minimum standards paper was aimed at (1) strengthening the application of the principle of consolidated supervision to all internationally active banking groups, (2) adding a further element of discipline to practices surrounding the cross-border establishment and maintenance of banking offices, and (3) promoting a still higher level of communication and coordination among the international community of bank supervisors.

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Considerable effort was expended in seeking to achieve these objectives in a flexible manner that

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continues to rely heavily on the goodwill existing within the international community of bank supervisors. In this connection, the Committee fully recognizes that there are a number of good and sufficient reasons that current supervisory practices in some national jurisdictions may not conform fully to the methods of consolidated supervision typically practiced within the Group of Ten. For that reason, the standards are designed to provide a margin of flexibility, especially for countries that are working toward effective approaches to consolidated supervision of their own banking institutions having, or wishing to have, a cross-border presence. The Committee and its secretariat are fully prepared to work with individual countries or groups of countries in facilitating the transition to the universal application of the policy and practice of consolidated supervision.

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The Committee has commissioned a working group of lawyers to look into the problems and difficulties encountered with the post–July 5, 1991 liquidation of BCCI. This "case study" is intended to help better understand the enormous legal and practical problems that can arise in connection with the liquidation of a banking institution with multiple cross-border offices.

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Second, over the past several years, the Committee has been engaged in the process of seeking to find sound and workable ways to build into the 1988 Basle Capital Accord explicit *minimum* capital requirements for market risk. The aim has been to provide for such capital requirements on net open positions in traded debt and equities (including their derivative instruments) that are held in banks' trading books. Similar capital requirements are contemplated for net open foreign exchange positions.

The work of the Committee as it pertains to capital requirements for debt and equities has been proceeding jointly with the work of the Technical Committee of the International Organization of Securities Commissions (IOSCO) in the hope that a comprehensive arrangement that will apply equally to banks and securities firms can be put in place. While considerable progress has been made in reaching this objective, there are a number of important areas in which agreements within and between the two regulatory bodies have yet to be reached.

As those efforts continue, the Basle Committee is mindful that achieving a higher degree of convergence between its efforts and the Capital Adequacy Directive, which is in the final stages of adoption by the European Community, is also desirable. Because of the lengthy consultative and phased implementation process that will have to be associated with the overall market risk effort, the Committee believes that the necessary convergence between Basle and Brussels can be realized over time, and the Committee is fully prepared to continue to work with our colleagues in Brussels toward that objective.

The approach to capital requirements for market risk that the Committee has in mind entails a two-step process aimed at satisfying two principal objectives. The objectives are: first, that the methodologies used to determine the amount of the capital requirements result in reasonably prudent cushions of capital protection against the potential for declining values in portfolios of traded debt securities, equities, and foreign exchange; and second, that the capital requirements across the three classes of instruments produce roughly equivalent economic results so as not to introduce artificial incentives favoring one class of instrument relative to others.

The specific process for estimating the amount of the minimum capital requirements for each class of instrument is, unfortunately, more complex than the Committee would wish. The complexities arise in part because the activities themselves are complex, but also because the computational techniques must take account of hedging and other complex trading strategies in order to arrive at reasonable approximations for the net open positions to which the capital charge factors would apply.

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These complexities aside, a two-step process is contemplated for integrating the capital requirements in the 1988 Basle Accord. In the first step, the minimum capital requirements for net open positions for each class of instrument would be calculated. In the second step, the aggregate capital requirements for market risk would have to be integrated with the capital requirements for credit risk under the 1988 framework. Under this approach, the extent to which individual banks will face greater *total* minimum capital requirements than is the case today will vary depending on the size of the bank's *open* positions in these instruments and the extent to which market risk capital requirements are a partial substitute for existing credit risk capital requirements.

Within the context of efforts aimed at convergence with IOSCO and Brussels, the goal of approximating competitive equality across different classes of institutions will entail some limited modification of the definition of capital. Specifically, it is contemplated that banks will be permitted to meet a fraction of the overall capital requirements for *market risk* by using particular forms of subordinated debt in a manner that is similar and proportional to the use of such capital by securities firms. For its part, however, the Committee retains a conservative bias with regard to the definition of capital and would entertain change in the existing definition only for the sake of material convergence with IOSCO and Brussels.

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Within the context of the market risk exercise, the Committee is also exploring the larger question of interest rate risk as it pertains to a bank as a whole. While it would be premature to anticipate the results of these efforts, it is probably safe to say that the Committee has a rather strong predisposition to try to deal with this issue through an approach that seeks to identify "outliers" and to deal with such outliers on a case-by-case basis, rather than a generalized approach that would rely on still another set of additive capital requirements for overall interest rate risk.

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Third, for readily understandable reasons, the Committee is taking a fresh look at supervisory practice and policy as they relate to various categories of off-balance-sheet activities. In part, these efforts are incorporated into the market risk exercise outlined above. Beyond that, we are also looking anew at some of the methodologies and capital weights that the 1988 Accord applied to the credit risks arising from some of these activities. Finally, and over a somewhat longer time frame, the Committee is mindful that the continued very rapid pace of innovation may require some further changes in basic accounting and statistical reporting requirements for at least some off-balance-sheet activities.

The latter, however, is potentially a very large and very expensive task that must be approached with great care. Partly for that reason, the Committee welcomes the recent creation of the Group of Thirty study group on off-balance-sheet activities. The perspective provided by this and other private initiatives will be of considerable value to supervisors and market participants alike as all parties seek to forge sensible and balanced approaches to the oversight and regulation of off-balance-sheet activities.

The Committee is keenly aware that banking groups by themselves, but especially in combination with insurance and securities firms, are becoming very complex organizations. This trend raises a number of very difficult questions, not the least of which relates to the manner in which the principle of consolidated supervision can be applied effectively to such institutions, especially in the case of so-called financial conglomerates.

Fourth, the Committee is keenly aware that banking groups by themselves, but especially in combination with insurance and securities firms, are becoming very complex organizations. This trend raises a number of very difficult questions, not the least of which relates to the manner in which the principle of consolidated supervision can be applied effectively to such institutions, especially in the case of so-called financial conglomerates. Some of these problems are definitional, including the very difficult task of defining how different regulators with responsibilities for one part of such a conglomerate can best coordinate their activities with other regulators within and across national boundaries.

While these and other practical problems are formidable, a far more difficult issue that can arise in this connection is whether efforts aimed at the supervision of such conglomerates may not, by their very nature, escalate the so-called moral hazard problem in ways that may be unwise from a broad public policy perspective. This potential problem becomes even more difficult in cases involving mixtures of regulated financial and unregulated nonfinancial entities, especially when the parent or lead entity is an unregulated nonfinancial institution.

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In the months ahead, the Committee plans to broaden its efforts in this area by establishing an informal group of experts drawn from the ranks of banking, securities and insurance regulators to look at these issues. It is hoped that this group, together with parallel efforts under way within IOSCO and in Brussels, will shed some more definitive light on how best to approach these most difficult and important questions of practice and policy.

This overview of some of the current initiatives of the Basle Committee is interesting in its own right, but to the community of supervisors its value should lie not in its specifics but rather in the message that those specifics are conveying about the broad environment in which we must discharge our responsibilities. That message is, of course, that the world of banking and finance has become very complex and perhaps more risky as technology, competition, and deregulation irreversibly alter the framework within which financial institutions and their supervisors must function. As I said earlier, I believe a case can be made that the challenges facing the international community of supervisors are as great today as they have been at any time in the postwar period. That being the case, it is important that we have a vision as to what may lie ahead as we seek to adapt our ideas and our ideals in a manner that is sensitive to the past but alert to the future.

With that in mind, let me now share with you some thoughts I have about some of the challenges that may confront us in the period ahead. I hope that this overview will help us better see not merely *what* we should be doing but, more important, *why* we should be doing it. I will try to provide some of this perspective by

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referring to four particular points of interest and will then close with some comments on recent experiences that a number of countries have had with debt-induced bubbles in real estate and other asset prices. The four particular points of reference include the following:

First, given all of the banking and financial problems that have emerged over the past ten years, one must be impressed with the resilience of the international banking and financial system. Indeed, whether it was the LDC debt crisis, bank

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failures or near failures, the stock market crash, real estate and other asset price bubbles, the recent turmoil in foreign exchange markets, or the financial scandals that have rocked many markets and institutions, the system has held up remarkably well. Moreover, in the face of all of this turmoil, and in no small way reflecting the impetus provided by the 1988 Basle Capital Accord, many banks and national groups of banks have substantially strengthened their capital base in recent years. At the same time, many developing countries as well as the nations of Eastern Europe and the former Soviet Union have made notable progress in the development of market-based banking systems in which private ownership of banks is the emerging trend.

When we consider all that has been achieved and all that *might* have gone wrong over this period, it would be easy for bankers and supervisors to conclude that the worst is behind us and smooth sailing lies ahead. Unfortunately, I believe that any such conclusion would be distinctly premature. For one thing, we all recognize that the global economic outlook is subject to consider-

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able uncertainty. We also know that the well-being of the international banking system is by no means independent of the near- to intermediate-term prospects for economic performance. For this reason alone, supervisors can ill afford to relax the vigilance that has been heightened over recent years. Indeed, I would go one step further and suggest that still greater efforts are needed (1) to further strengthen supervisory policies and practices and (2) to shape those policies and practices in a manner that recognizes and rewards the strong and the prudent while penalizing the weak and the reckless. To put it differently, the many strong and well-managed institutions should not be held hostage to supervisory policies and

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practices that are driven by the mistakes or misdeeds of the few. Achieving this more selective approach to dealing with problems and abuses becomes all the more important in a setting in which banks in most countries are now facing very stiff competition from less regulated, or even essentially unregulated, nonbank institutions.

Second, while we are all understandably preoccupied with the daunting task of trying to keep pace with the latest developments in this world of "high-tech" banking and finance, we should remember that, almost without exception, the most serious banking problems encountered in recent years have grown out of old-fashioned difficulties with bad loans and excessive concentrations. That, of course, is not meant to suggest that we can ignore contemporary developments. But it does mean that as we seek to cope with new trends and new risks, we cannot relax our surveillance, inspection, and examination programs as

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they pertain to traditional concerns about asset quality and concentrations. For many supervisory authorities—certainly including the Federal Reserve—these dual concerns with new and old sources of problems will mean that still greater and more sophisticated resources—people and technology—will have to be devoted to the supervisory process. This will be costly, but the alternative would be even more costly.

Third, while we and others can all engage in a lively debate about whether international banking in the nineties is likely to be more or less risky than it has been in the past, I believe we would all be well served to operate on the *assumption* that systemic risk may be greater as we look ahead. I say this with the full knowledge that various hedging techniques provide ample opportunities for individual institutions to manage and contain their risks. My suggestion that systemic risk may nonetheless be greater might therefore seem contradictory, but it is not. The reason that it is not is that

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the speed, volume, value, and complexity of international banking transactions have introduced new linkages and interdependencies between markets and institutions that have the potential to transmit problems and disruptions from place to place and institution to institution at almost breakneck speed.

This is the fundamental reason that supervisors must be concerned about the astronomical growth of off-balance-sheet and related activities and about the financial and operational integrity of national and international payment and settlement systems. It is also why supervisors and practitioners alike must redouble efforts to design and implement truly safe and robust netting systems even though we all recognize that the legal and other obstacles standing in the way of that objective are very formidable, especially in an international setting.

Fourth, for better or for worse, banking supervision has taken on a high public profile in many countries. In the wake of all the problems of the past ten years, that is understandable. And in many ways we should welcome that higher public profile, even if it carries with it the sometimes uncomfortable feeling of greater accountability.

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This heightened public profile is not, however, without its problems. For example, it can bring with it the suggestion that prudential policies should be used in a countercyclical fashion, an approach that strikes me as very dangerous indeed. Similarly, it can bring with it the misguided belief that bank supervisors should be able to detect and prevent every problem, including fraud, deceit, and dishonesty. Finally, it can bring with it the wholly misguided notion that bank supervisors are surrogate bank managers, thus blurring if not erasing the vital distinction between the role of bank supervisors on the one hand and bank managers on the other.

I raise these potential dangers in part because they can become quite real but also because they should remind us of a much more fundamental point. Namely, banking supervision is an art, not a science. It cannot be, and should not be, failsafe. It cannot be, and should not be, reduced to a series of formulas and ratios. Its principal focus should be the well-being and safety of the system as a whole. Its principal modus operandi should be hard and rigorous analysis, generously seasoned with experience and judgment. But it is up to the supervisory community itself to understand and to articulate the objectives and limitations of the supervisory process. To the extent that the community of supervisors does this well, it will flourish in the sunshine of its heightened public profile.

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Earlier I said that I believe it would be distinctly premature for banks and bank supervisors to conclude that the worst is behind us and that smooth sailing lies ahead. One very forceful reminder of why I hold that belief can be found in the fact that so many countries—starting with my own—are mired in patterns of sub par economic growth, the causes of which are at least partially related to credit-induced real estate and other asset price bubbles during the second half of the 1980s.

To some extent, this phenomenon can be explained by country-specific developments. For example, informed observers generally cite some or all of the following in seeking to explain the situation in the United States: (1) the combination of the 1981 and 1986 tax acts, (2) the growing importance of nonbank financial institutions, (3) the rapid growth in capital markets in general and securitization in particular, and (4) technological change and innovation in banking and finance. While it is no doubt true that these factors played a role in the debt and real estate excesses in the United States, they do not appear to have been nearly as important—and, in the case of the U.S. tax legislation, not even present—in other countries that have experienced similar ailments.

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Thus we face the nagging question why so many countries, in seemingly different national circumstances, experienced broadly similar problems. One possibility is that the incidence and timing of these problems were sheer coincidence. Another is that these developments can be attributed to sunspots or some mystical phenomenon. Still another—and the more plausible—possibility is that there are common denominators that can help to explain why these events have occurred in so many places at about the same time.

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The obvious place to look for common denominators would be in the area of macroeconomic performance. Specifically, history would suggest that credit-induced speculative bubbles would be most likely to occur in circumstances of high and accelerating inflation and low or negative real interest rates. On the whole, however, these conditions were not characteristic of the period in question. That is, while inflation was clearly a matter of continuing concern in most countries, there was not a widespread outburst of generalized and cumulating inflationary behavior. And in most countries, real interest rates, as generally measured, were distinctly on the high side relative to historical norms.

Despite these considerations, two phenomena seem to have been more or less common to the countries that experienced credit-induced speculative bubbles. Those two common elements are as follows: first, it does appear that the rise in land and/or real estate prices tended to be much greater than the general rate of inflation; and, second, it appears that the rise in private debt accumulation relative to nominal GNP was more rapid than would normally be expected. In these areas the correlations are less than perfect but the tendencies are clear enough. But even if the correlations were nearly

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perfect, that would still raise the question why these tendencies developed.

In other words, why did developers and others borrow so much (especially at seemingly high real interest rates) and why did institutions and markets provide so much credit when, at least in the United States, half-empty or empty office buildings could be seen simply by looking out the window of the office in which the agreements for still more construction loans were being signed?

Part of the answer to that question is obvious in that borrowers and lenders alike had to have believed that inflation—at least of a selective nature—would eventually bail them out. It is perhaps also true that decisions to lend and to borrow were easier to reach and to justify in the "go-go" financial environment of the 1980s. Whatever the precise psychology of the situation, the financial culture of the 1980s was somewhat similar to the boom and bust environment of the nineteenth and early twentieth centuries, a similarity that was no doubt nurtured by the fact that so many of the direct participants to the process of the 1980s lacked the historical experience or the perspective of these earlier times.

Looked at in this broad light, several things can be said: first, to some extent the credit excesses of the 1980s can be partially explained by a number of country-specific factors; second, notwithstanding a relatively benign overall inflationary environment and relatively high real interest rates, borrowers and lenders alike

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clearly went overboard; third, some part of those excesses had to have been encouraged by at least selective inflationary expectations and by a culturally induced "disconnect" with earlier history and experience. These considerations probably constitute a reasonable summary of the *necessary* conditions for the widespread incidence of credit-induced speculative bubbles in so many countries, but they do not constitute *sufficient* conditions to explain all we have seen. Those missing sufficient conditions are, in my judgment, to be found in the application of very sophisticated telecommunications and computer technology to money, finance, and economic activity more generally, with all of their implications for the globalization of financial markets and institutions.

We all know that technology has profoundly changed the day-to-day business of banking and finance. Some of that change is an outgrowth of the speed and ease with which information can be assembled and communicated; some of it is an outgrowth of the speed, relative safety, ease, and low cost with which money and capital can move from place to place around the globe; and some of it relates to computational capabilities that make possible the design of financial instruments, trading practices, and investment strategies that would have seemed almost unimaginable only a few short years ago.

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fresh sources of capital and finance and to arbitrage not simply interest rates and exchange rates, but even price differentials between office buildings and shopping centers on a global scale. These technological forces are also one of the fundamental reasons that the value of the traditional bank "franchise" has been reduced in many countries, thereby introducing important new elements of competition in the financial marketplace that may permit, if not encourage, a higher degree of overall leveraging than might otherwise have been the case. All of this, I believe, is the missing link in efforts to explain why credit-induced asset price bubbles have been able to move with such relative ease from one spot on the globe to another.

Taken as a whole, the foregoing analysis raises two important questions: first, was the experience of the late eighties a onetime phenomenon or has the character of finance changed so fundamentally that we will see the experience of the last several years repeat itself—with all of its implications for economic performance and stability? Second, what does all of this imply for supervisory policies and practices?

The answer to the first of those questions does not come easily. On the one hand, it can easily be argued that the costs to borrowers and lenders alike for the excesses of the 1980s have been so large that the hard lessons learned will not be forgotten quickly or easily. I hope that will be the case, but if it is, it presupposes a renewed and pervasive commitment to the principle of prior restraint in the credit origination process on the part of borrowers and lenders alike. It also implies the need for what I will call the "taming of technology," and by that I mean the fuller development of risk management and management information systems that will provide the top management of financial institutions with the tools and the information to ensure that applied technology is being used in a safe, sound, and prudent manner. Fortunately, great progress is being made in this area, but still greater strides will be needed even though such efforts are very expensive and very time consuming. Beyond that, the realities of today's and tomorrow's world of banking and finance will place an even greater premium on the time-honored basics of strong management, diversification of risks, a thick capital cushion, and broad and deep liquidity. With these elements firmly in place, the likelihood is great that we can avoid a repeat of the excesses of the second half of the 1980s.

The realities of today's and tomorrow's world of banking and finance will place an even greater premium on the time-honored basics of strong management, diversification of risks, a thick capital cushion, and broad and deep liquidity.

However, even if things do work in that happy direction, the task ahead for the supervisory community will be great indeed. For one thing, the hangover from the excesses of the 1980s is far from behind us, even though considerable progress has been made in that regard. But even as that process continues and even as macroeconomic prospects brighten—as they surely will over time—the supervisory community must do its part to help ensure that the international banking system will reach calmer waters. In seeking to play our necessary role in facilitating that transition, none of us is capable of foreseeing all that may lie ahead. Yet our agenda is clear enough, even though fulfilling that agenda will require an enormous amount of effort and the willingness and flexibility to respond to unforeseen developments.

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We know that there will be problems and pitfalls. We also know that a great deal is expected of us—perhaps more than is reasonable. But with vision and vigor, with intelligence and integrity, and above all, with the expectation for the best but a healthy respect for the worst, I am confident that we can and will succeed.