Supervisory Capital Standards: Modernise or Redesign?

Edgar Meister

I. I am delighted to have the opportunity to speak to such an eminent group at this important conference on capital regulation.

“If you see a banker jump out of the window, jump after him: there is sure to be profit in it,” said the eighteenth-century French philosopher Voltaire. Looking at the situation in Southeast Asia, I am not entirely convinced that it would always be wise to follow Voltaire’s advice. Even if all banks pursue the same course, their actions are not necessarily appropriate.

It is also becoming clear, however, that the Asian crisis has given new urgency to the already important topics of risk and capital adequacy. In that respect, this conference has come at a very opportune moment.

The question addressed by this conference is whether the prudential supervisory standard established by the 1988 Basle Capital Accord can meet the challenges of the twenty-first century. If an entirely new standard is needed, then our task is to consider which alternative system of capital requirements might be superior to the present one. There are differences of opinion on these issues, not only between the supervised institutions and the supervisors but also, in some cases, among the supervisors themselves.

In debating whether it is better to modernise the Basle Accord or to redesign it by developing a new set of capital rules, we need to keep two considerations in mind:

• A capital standard should promote the security of individual institutions—that is, each institution’s ability to manage risk and to maintain an adequate cushion of capital against losses—and the overall stability of the banking system. I assume that no one wants less financial market stability than we have now.

• The easing of regulatory burdens and the creation of a level playing field for banks are important objectives. Although the extent of the regulatory burdens imposed by different capital standards should not be the main criterion in deciding whether to modernise or redesign the Basle Accord, efforts to streamline regulation are welcome because they reduce the competitive disadvantages experienced by banks and optimise the cost-effectiveness of the supervisory system. A related consideration is that any prudential measures taken should not create competitive discrepancies between different groups of banks.

Edgar Meister is a member of the Board of Directors of the Deutsche Bundesbank.
II. In terms of risk considerations, an ideal capital standard would fully capture an institution’s risks and would produce a capital base that takes due account of risk. An ideal standard would also increase market discipline. In reality, we are still far away from these theoretical ideals. There are differences in the measurability and hence also in the controllability of the main risks to which banks and other financial intermediaries are exposed. Market risks, for example, can be measured quite accurately using existing data and risk-monitoring techniques.

By contrast, in what is still the main risk area for banks, credit risk, a purely quantitative determination of risk—comparable to market risk modeling—is much more difficult and has not yet been achieved. For that reason, assessment of credit risk still relies heavily on traditional methods—that is, the judgement of the banks’ credit officers.

Efforts to improve the quantification of credit risk through the use of models are mainly hampered by insufficient or poor-quality data. For that reason, the survey of data sources for credit risk models that was recently released by the International Swaps and Derivatives Association (ISDA) is very welcome. It remains to be seen, however, whether the quality of the data in major market segments will be adequate.

Data problems also complicate the modeling of operational risks. These risks range from the inadequate segregation of duties to fraud and errors in data processing. At present, measures of these risks are “guesstimates” based largely on data not objectively observable.

III. The difficulties in risk measurement are a problem not only for institutions, but also for the supervisory agencies that define capital requirements. Our existing regulatory framework aims to ensure that institutions have an adequate cushion of capital as a protection against unavoidable losses. Although this “shield” of capital is supposed to cover all risk factors—including operational and legal risks—the calculation of required capital has essentially been geared to a single risk factor: default risk. At the beginning of this year, separate capital requirements were implemented for banks’ market risk exposures, but default risk remains the primary target of capital rules.

Bankers and some supervisors have recently called the Capital Accord into question, not least because of its inexact categorisation of risks. They point out, for example, that exposures to countries in the Organization for Economic Cooperation and Development are assigned a uniform risk weight of 0 percent, although there are considerable differences in risk within that group of countries. Similar questions arise about the assignment of a 100 percent risk weight to exposures to nonbanks, a group that includes blue-chip firms known worldwide. Additionally, critics claim that risk weights under the Basle Accord do not take into account the degree of diversification in individual institution’s loan books—an oversight that may prevent institutions from using their funds in the most productive way.

IV. This is the backdrop against which more sophisticated methods of credit risk measurement are being discussed. These methods include a subtly differentiated prudential weighting scheme, the use of internal ratings, the inclusion of portfolio effects and credit risk models, and certain new concepts completely different from the Capital Accord. It is my assessment that supervisors are fundamentally open-minded about these alternatives. Notable among the new concepts are the precommitment approach put forward by economists from the Board of Governors of the Federal Reserve System and a framework that emphasises self-regulation, proposed by the Group of Thirty (G-30).

Under the precommitment approach, a bank itself decides how much capital it will hold within a given period to cover the risks arising from its trading book. Sanctions will apply if the accumulated losses exceed that amount. This approach is appealing in many respects. It could ease the job of supervisors and reduce the regulatory burden for institutions. Moreover, the approach is highly market-oriented.

The precommitment approach poses a number of fundamental difficulties, however. First, it involves a purely ex post analysis of a bank’s risk and capital status.
This perspective means that supervisory authorities are reacting to market outcomes and to choices already made by an institution rather than specifying a given level of capital for the institution in a preventive manner. Without wishing to preempt this afternoon’s discussion, I would argue that some institutions facing regulatory sanctions for failing to commit sufficient capital to cover their losses might be motivated to accept additional risk—on the theory that “If you are in trouble, double.”

A second problem with the precommitment approach is the difficulty of finding a logically consistent penalising mechanism. If an institution takes risks that result in losses greater than the capital reserved, banking supervisors would have to impose mandatory fines or higher capital requirements, which would end up exacerbating the financial difficulties of that institution.

Another penalty contemplated under the precommitment scheme—public disclosure—points to a third problem with this approach. The idea that an institution could be required to inform the market if it failed to limit its losses has met with considerable reservations on the part of many institutions and supervisory authorities. I am quite doubtful whether institutions would be prepared to go that far in terms of disclosure. At the risk of exaggeration, I would suggest that the precommitment approach represents a bank’s promise that it will not become insolvent. If that promise cannot be kept, then the question whether supervisors can or will impose sanctions remains open—at least in critical cases.

A proposal by the G-30, which goes further than the precommitment approach in reducing the role of bank supervisors, essentially leaves the development of regulatory strategies to the market or to a small group of major international financial institutions. The involvement of supervised institutions in the creation of regulatory standards is not new in principle; it has been tried and tested. Whenever industry methods of measuring and monitoring risk have become state of the art, supervisors have been ready to adopt them—as was recently the case with the recognition of internal models for market risk. Nevertheless, in the absence of administrative sanctions to enforce standards, how binding could those standards be?

V. As concepts, the precommitment approach and the G-30 proposal for self-regulation supply important and thought-provoking ideas. Because of their pronounced market orientation, these alternatives to the present prudential standard would reduce the regulatory burden and give banks greater freedom in their risk management.

At the same time—in addition to the reservations already mentioned—I perceive the danger of a decline in the overall security level of the individual credit institution and the banking system. Existing risks might be covered by less capital than under the Capital Accord.

Although self-regulation aimed at greater market discipline would be welcome, the precommitment approach and G-30 proposal would probably not be able to achieve it on a lasting basis—especially if a bank or a banking system were in a difficult situation. In such a situation, these alternative approaches would not be able to make up for the disadvantages of allowing institutions to maintain a lower capital base.

What should also be given consideration is that both approaches are intended to apply mainly to large banks that operate internationally. These institutions are players with an especially prominent role in maintaining the stability of the financial markets. At the same time, we know that the world of risk has become more complex during the last few years and that the risks borne by institutions under the pressure to perform have increased. Risky
high-yield transactions in emerging markets, for example, are likely to become increasingly significant in the future despite the recent turmoil in Asia.

Indeed, the events in Southeast Asia demonstrate how difficult it is to determine bank-specific risks with sufficient accuracy. Even leading rating agencies have tended to run behind the markets in line with the maxim “Please follow me, I am right behind you.”

VI. Capital is, therefore, still a modern prudential requirement. The Basle Capital Accord is, in this context, a rough and comparatively simple approach. This standard, which has now been put into practice virtually worldwide, undoubtedly has some weaknesses. It has, however, demonstrated its suitability under changing conditions in the almost ten years since its introduction. In my view, the empirical findings are definitely positive.

The Capital Accord has not worked, however, when the calculated capital was not actually in place. In many countries that have experienced crises, credit institutions had only formally fulfilled the norm of 8 percent minimum capital. An evaluation of actual assets and liabilities in line with market conditions would have shown that the capital had been used up long beforehand.

Because the Capital Accord sets capital requirements more conservatively than do the precommitment approach and the G-30 proposal, there remains a buffer for cushioning the risks that are difficult to measure—operational and legal risks, for instance. To that extent, an adequate cushion of capital can make up for shortcomings in risk identification, measurement, and control.

VII. To come back to the original question: I am in favour of an evolutionary solution. The Basle Accord should be modernised and not—at present—replaced by other concepts. Other approaches are indeed worth discussing, but at present I cannot identify any alternative that would be operationally viable, practicable, and superior to the Capital Accord.

The Capital Accord itself is adaptable enough to allow new developments in the markets to be integrated with its system in a meaningful manner—as occurred in the case of market risk, for example. It can also accommodate all other developments currently under discussion, such as on-balance-sheet netting, credit derivatives, credit risk models, and new capital elements.

The capital requirements established by the Basle Accord will, of course, have to be expanded to include buffers for risks that have so far gone uncovered. For example, given an easing of capital requirements in other areas, buffers for operational risks, valuation risks, and concentration risks must no longer be a “no-go” area.

Generally speaking, further qualitative requirements may also help to curb risks and hence create a stabilising impact in micro- and macro-prudential terms. In that respect, the Basle Committee’s “Framework for the Evaluation of Internal Control Systems” is especially important. Qualitative and quantitative minimum standards for the use of credit risk models—validated through extensive testing and application—would also have to be specified in due course.

In my view, self-regulation can have a stimulating effect, but it cannot replace the administrative supervision of banks and other financial intermediaries. To that extent, self-regulation is an approach that complements prudential supervision. I believe that this assessment has been reinforced by various bank crises in the past and borne out yet again by the Asian crisis.

A revised capital framework incorporating greater self-regulation requires that supervisors work closely with financial institutions. Such cooperation should yield regulations that are, on the one hand, up-to-date and compatible with the market and, on the other hand, conducive to market discipline and the stability of the overall system.