BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

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Risk Sensitivity and the New Basel Accord – Speech by David Clementi

In a speech to be delivered today at an FSA Conference, David Clementi, Deputy Governor, discusses the implications of the New Basel Accord not only for banks but for the financial system more generally and the possible impact on financial stability.

Mr Clementi welcomes the New Accord and the introduction of more risk-sensitive capital requirements. However he highlights areas where there may be too little risk sensitivity in the proposals. For example, the treatment of unrated credits in the revised standard approach may act as a disincentive for banks to move to the more sophisticated internal ratings approach developed in the New Accord. This may over time result in the worst-quality credits gravitating to those banks least able to assess, price or monitor them. It is important that the new Accord provides the right degree of capital incentives for banks to progress to using internal ratings. Supervisors will also need to recognise that the risk weights in the standard approach represent a floor and in Pillar 1 require more capital for unrated credits if that is needed. Under Pillar 2 of the Accord, supervisors must ensure that banks have a level of capital requirements appropriate to their risks.

As Mr Clementi points out, any capital incentive to progress to risk-sensitive measurement has to be balanced against the objective of roughly maintaining the overall amount of capital in the financial system. "It would be dangerous to financial stability if we gave so large a capital carrot to banks to use the internal ratings based approach that many of the world's most important financial institutions, which account for the vast bulk of global and G10 domestic banking activity, saw a significant reduction of their regulatory capital requirement. It is the need to balance incentives with the maintenance of overall capital levels which makes this issue a difficult one." With this in mind, the Basel Supervisors Committee has set in train a quantitative impact study, co-ordinated by the Bank of England, to calibrate the impact of the New Accord on individual institutions and on the system as a whole.

Mr Clementi also addresses the question of procyclicality and the possibility that risk-sensitive capital requirements will exacerbate economic downturns. In the implementation of the New Accord, it will be essential that banks' internal ratings are not "point in time" but take account of a long run average probability of default. "Ratings ought to be forward-looking and robust to the normal ups and downs of economic activity."

Finally he notes that capital is only one component of banking stability. He draws attention in particular to the importance of valuation and provisioning frameworks; and to the prudent management and regulation of liquidity.

Notes for Editors

1. The FSA Conference on "Reforming Capital Adequacy for Banks, Building Societies and Investment Firms" is being held on 10-11 April, 2001 at the Queen Elizabeth Conference Centre in London.

2. The Second Consultative Package on the New Accord was published in January. The New Accord is due to be published in final around the end of 2001 for implementation in 2004.

3. The Bank of England and the FSA are both represented on the Basel Committee on Banking Supervision which is responsible for drawing up the Basel Accord.

Key Resources

Risk Sensitivity and the New Basel Accord – Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2001/speech122.pdf