Banking risks in an evolving market

*Opening a conference on banking control and supervision[1] the **Governor** observes that banks have recognised and responded rather well to the increased risks they face in a changing world. Coaxed and encouraged by their supervisors they have adopted higher rates of provisioning and generally improved their capital ratios. New types of business that are constantly evolving, often of a highly complex nature, bring new risks and challenges. Some of this business, and the associated risks, are off the balance sheet but it nevertheless requires adequate capital to support it. The **Governor** concludes by noting that banks must continue to strengthen their resources—capital and manpower—and must seek to develop and adapt their control systems.*

The macroeconomic background

If I may, I should like to reflect on some of the factors which account for present uncertainties. Most are, of course, rooted in the rather dramatic macroeconomic developments of the past few years to which banks have had to respond by adapting their business strategies and evolving new instruments. This is, of course, a dynamic process accompanied by the development of additional or different risks.

The movements in prices of commodities, and in particular of oil, have been substantial in the last fifteen years or so. The impact of these changes has varied markedly from country to country. Some countries have been able to cope rather more smoothly than others, and some, of course, have had resources which have helped to cushion the impact.

There have also been large discrepancies between growth rates and inflation in major industrialised countries. A greater measure of convergence is now being achieved between the major economies, yet we wait to see any lessening of the volatility shown by the financial markets. Banks are still facing the effects of the earlier shocks and the concerns about the creditworthiness of particular borrowers. Indeed the health of borrowers is closely related to movements in commodity prices and in interest and exchange rates. What appeared to be good assets at the time the loans were put on the books, can now look rather sick. In some cases, I have to say that credit assessment in the past may have been inadequate. I do not think we should underestimate the extent to which the world has changed. It has changed whether the borrower is a major developing country or a company in a now troubled sector. Rescheduling has followed, and the banks and borrowers have also set about examining how they can minimise the effects of price, interest rate and exchange rate volatility in the future.

We have come some way in relation to international debt difficulties since the dark days of 1982–83 and many of the countries in question are making progress under economic programmes worked out with the IMF and the banks. Nevertheless, uncertainties continue to hover over major borrowers which have rescheduled. This presents the banker with a dilemma. He cannot be expected to look with much enthusiasm on the provision of additional lending. At the same time, however, where a country can establish sound economic programmes and then reschedule its debts, it is in the interests of international financial stability and the banks themselves to continue to lend, albeit on a more modest scale.

Banks' capital

The banks have recognised and responded rather well to the increased risks they face. Across the world they have adopted higher rates of provisioning both on their domestic business and against their international lending and there has been a general improvement in capital ratios. Both these desirable trends have resulted at least in part from an increasingly firm stance by supervisors. They have also paid greater attention to the quality of capital.

Perhaps I might now say a word about the issues last week by two major UK banks of perpetual capital notes. As you may recall, the Bank published a paper on aspects of subordinated loan capital last November, and that paper attracted a degree of criticism on the grounds that it was too rigorous. We have held many discussions with banks since then, and I am very pleased to note that several term issues which met our conditions have been successfully launched. Now we have seen that two perpetual issues, which are in substance the same as the instrument we envisaged in our November notice, have been well received. We recognise that we are being rigorous, but we firmly believe that this is in the long-term interests of the banking community.

More generally, although supervisors have come to play a more active role, I do not think that the tensions between the supervisor and the supervised have been as great as is

(1) Arranged by the Arab Bankers' Association in London, on 7 May.

sometimes suggested. Banks may sometimes have had to be coaxed but often they have afterwards accepted the validity of our concerns.

Risks associated with new banking activities

I referred earlier to foreign exchange activity. To judge from experience in London, banks have responded well to the risks inherent in volatile exchange rates. Most of them have shown acute perception of the risks, good control over their dealers and the determination to cut losses whenever they reach predetermined limits, rather than attempting to retrieve them through continued speculative trading. However, this is a well understood area of banks' business where risks have been identified and analysed over a long period. The same cannot be said of some of the newer forms of activity which are now being undertaken and where both banks and supervisors still have much work to do to arrive at a full understanding of the risks and then to specify the necessary response.

In discussing these new kinds of activity, I should like to stress that the Bank of England is in no way opposed to banks taking on new kinds of business which are natural extensions to services offered to their customers. Indeed we would regard a well-diversified banking business as possessing an inherent source of stability, although it is often difficult to know precisely how certain types of business which banks undertake nowadays should be fitted into the normal structure of a bank's business.

Securities trading is perhaps an example, since the capital requirement of a dealing firm, which may from time to time hold very large trading positions in securities, is different from that necessary to support a conventional lending bank. But there are difficult judgements to be reached in determining what is the right amount of capital for a securities dealer. From one point of view, a dealer can afford to have a lower ratio of capital to assets than a bank, since the dealer's assets are by definition marketable at a price, whereas the lending banker cannot normally expect to be able to sell a doubtful loan. On the other hand, securities markets can be very volatile and I do not suppose there are any dealers who have always got their trading positions right when the market turns. These are the sort of considerations which have to be weighted, one against the other.

Partly in response to the general uncertainties about which I spoke earlier, banks have been showing great interest in, to use that rather ugly word, the 'securitisation' of lending. Making assets marketable and thereby potentially enhancing banks' liquidity looks attractive, but again it sets in train processes which need to be examined carefully. Perhaps only the best loans can be sold and, if so, does the average quality of a bank's book become diluted? Some of us worry about this. Again, the fuzzy boundary between banking and other financial activity becomes even more blurred.

However, most of the rest of the new forms of business being undertaken by banks—for instance options, futures, forward rate agreements, interest rate swaps and note issuance facilities—do seem to me to be more normal extensions of banking business, although they do present major challenges to those who have to devise controls. Part of the problem is that many of the new types of business take place in trading rooms, and the general management—whose task it is to control the level of risk—will not always communicate easily with their traders because of the barriers posed by traders' somewhat esoteric jargon. Another difficulty is that the structure of these new forms of business is often highly complex. The mathematics which determine whether a bank is adequately hedged in its option business is taxing even to the professional mathematician.

But there is another issue—and an even more important one—than that presented by the technical difficulty of controlling off balance sheet risk. This relates to the way in which bankers look at supervisory requirements. Banks have perceived that here in London, and in many other countries, there have not been formal requirements for capital to back certain risks which are carried off balance sheet. As supervisors have sought to increase capital ratios, some banks appear to have looked for ways of doing effectively the same sort of business but off balance sheet—and thus without capital costs. The risks are in reality little different and the need for capital is still there. It is for bankers as well as supervisors to assess this need. It is against this background that the Bank of England recently erected a sign post to the market by imposing weightings for capital adequacy purposes on contingent liabilities incurred through note issuance facilities. Other national supervisors may well follow suit. The Bank of England is, in the coming months, to discuss further with the banks in London the whole subject of off balance sheet business.

The tone of my remarks today has been somewhat sombre but I speak against the background of banking problems which have afflicted so many countries. I cannot do more now than sketch the lines of our approach. I would like to suggest, however, that banks must continue to strengthen their resources—of capital and manpower—and seek to develop and adapt their control systems. New business should be undertaken only after careful consideration of all the risks and perhaps in some cases after dialogue with the supervisors. We are learning, too, and we have always stressed the value of a co-operative approach in a changing and difficult world.