# Some current concerns of a banking supervisor

*Mr W P Cooke, Associate Director, speaking*[1] *on some current supervisory concerns in international banking, discusses the problems of assessing capital adequacy in a world of rapid innovation brought about by deregulation. One consequence of deregulation is the growing complexity of financial services groups which raises new questions on the measurement and composition of capital. The appropriate level of capital needs to take into account risks resulting from business conducted off the balance sheet as well as the quality of assets on it. The role of bank auditors within the supervisory process and the impact of technological advances on the financial services industry are also issues to which further attention needs to be given.*

I am delighted to have been invited to this conference and to say a few words about some current supervisory concerns in international banking. In doing so, I will try to address some brief comments to the major issues which this conference is setting out to cover over the next two days. If I appear on occasions to be echoing remarks just made by the Governor, I excuse myself on the grounds that if something is worth saying it is worth saying twice.

But I would like to start by applauding the initiative of the Arab Bankers Association in conceiving and arranging this conference. It is said—and it is true—that international banking business is nowadays conducted in one enormous single market. But like the street markets in our towns and cities when you come to examine that market place more closely you find it consists of very many independent units, mostly in hot competition with each other. For success, each has to be master of his own trade but it is also important that all the participants operate within a reasonably homogeneous framework of rules without which everyone's individual efforts would be thwarted.

*... the interests of the banking supervisory authorities and good commercial bank management are one*

I commend, therefore, the work which is being done by the Arab Bankers Association to build quality and expertise in banking in the international community of which the Arab world is a part. And I am particularly pleased that in pursuit of these objectives they have conceived of the need to bring the bankers and the supervisors together. It has long been the perceived wisdom in the Bank of England that the interests of the banking supervisory authorities and good commercial bank management are at one. One sets out to construct, and the others to operate, within a sound framework in which the banking system can conduct its business with the full confidence of those who use its services.

The basic principles of sound banking may be the same the world over, but the regimes within which banking is conducted will differ in different regions of the world. The development of supervisory co-operation in coming to grips with this global market place recognises these common features and this has led to the development of groupings of national supervisory authorities which, while they may have many differences within their individual systems, will tend to have more in common than they have to keep them apart. Such groups have been established in the major industrialised countries, among the supervisory authorities in that group of countries whose banking markets are characterised as offshore centres, in Latin America and in the Caribbean countries and recently in the countries of South East Asia and the Pacific Basin.

Another natural group would seem to me to exist in the Arab world, notably among the major oil producers, where international banking business has developed strongly in the wake of the substantial revenues generated by oil earnings in recent years, but also among the non-oil countries. I welcome therefore both the efforts of the Arab Bankers Association to develop a better dialogue with the supervisory authorities and the prospect that this may be one manifestation of moves to develop a natural constituency of Arab banks and supervisory authorities with an important voice in fora such as this debating international banking matters.

*... important forces are being unleashed under the banner of deregulation*

Now what are these current matters of concern? In London in particular at present, and also in the United States, important forces for change are being unleashed under the banner of deregulation. This is not good news for the regulator whose framework of control within which banking and other financial services are undertaken, built up carefully over time, may have to be rethought and restructured. New instruments and new sources of profit may be being devised in an exciting new business environment but these carry with them new risks which the supervisor and the banker have to try to weigh up and assess.

(1) At a conference on banking control and supervision, arranged by the Arab Bankers Association, in London on 7 May.

The market place is bubbling with new ideas. For those supervisors who see their role as one of regulation not strangulation, to use my Governor's words, they are constantly having to work to keep up with, and monitor judiciously, the innovative and imaginative concepts and products being generated by commercial and investment bankers.

Some basic order is, however, critically important in well conducted markets and the supervisor has to judge carefully how far new ideas can have free rein and how far some fundamental constraints need to be imposed on the market and its participants. Among the most important of these constraints to market activity is the first question for consideration by this conference—that of capital adequacy—and I would like to say a few things about this as for supervisors it certainly ranks high among the concerns.

*Careful consideration is having to be given to the adequacy of capital in banks . . . engaged across a whole range of activities*

Capital adequacy measures are in many ways the most important and can also be one of the more flexible means by which the supervisor can exercise influence over banks. They are also becoming more and more important as a management tool for bankers as increasing attention is directed to profitability and particularly to return on assets. I shall take as given the need for capital adequacy; the debate, of course, centres around what is considered to be adequate and the ways in which it should be assessed.

You will all be aware that over the past three years or so the authorities have been pressing quite hard in encouraging improved levels of capital adequacy in international banks. This arose particularly from the appreciation of the increased risks which banks were running in their international book, and particularly medium-term sovereign risk business, but also from a more general feeling that the erosion of capital standards—largely through competitive pressures—had gone far enough. As a result of these efforts material improvements in capital levels have been achieved in some countries.

There is now a second range of questions which are having to be addressed concerning capital. These arise in connection with the current financial services revolution. Careful consideration is having to be given to the adequacy of capital in banks and in banking groups engaged across a whole range of financial, and even non-financial, activities.

For the supervisor, assessing the appropriate level of capital in such cases is a difficult exercise, not least because the proliferation of new instruments and areas of business introduces risks the nature and extent of which cannot be measured on the basis of historic experience. We are to some extent shooting in the dark.

*. . . the only sensible framework for assessing capital adequacy in multi-faceted groups is . . . dedicated capital*

As we consider these new problems in the context of the changes taking place in the United Kingdom we are in my view, and the debate is far from over, coming to the conclusion that the only sensible framework for assessing capital adequacy in multi-faceted groups is for some part of the overall capital in the business to be identified as backing particular parts of the business—the concept, as we would call it, of dedicated capital. Given the fact that in these groups there may well be regulators other than banking regulators exercising authority over certain parts of that business, any other approach would seem to me to risk regulatory anarchy. What is less clear is the extent to which different elements of the business need to be conducted within separately incorporated entities or how far the attribution of capital can be achieved through an earmarking process.

Another aspect of apportioning capital which will need further consideration is the particular treatment of banks within financial service groups. Banks, I believe, have rather special characteristics as a consequence of the supervisor's, and the market's, perception that at the end of the day a bank, in its own interests, will feel obliged to stand behind its subsidiaries. Bankers may need to recognise that this particular feature of banks may have an effect on the rules which are being worked out for groups of which they are a part.

In looking at capital in an international context, the broader issue of international competitiveness is becoming an increasingly significant consideration. Capital adequacy rules differ considerably in different countries both in the level of capital required and in the definition of what capital consists of. There is general support in principle for the level playing field concept—from banks themselves and from the supervisors. It is quite another matter, however, to apply it in practice and quite a lot of work is now being devoted to seeing how far it is possible to achieve a broader comparability of capital adequacy standards in international banking.

*. . . the definition of capital . . . is difficult*

The first stage in the analysis is the identification of the elements for inclusion in the definition of capital. This is difficult not only because of the different usage and vocabulary in different countries' systems, but also because of the current trend to invent new instruments incorporating minor or subtle variations to traditional capital instruments.

A good deal of effort has been and is being expended currently in trying to grasp these problems. There are some elements of capital on which there is ready agreement between supervisory authorities that they form part of the capital base—issued and paid up share capital, share premium account and published reserves. In many countries—and this country is one—general provisions

may also be included in capital where they are judged to be fully available to meet latent but as yet not specifically identified losses.

More contentious is the treatment of undisclosed reserves either in the form of reserve accounts concealed within the liabilities side of the balance sheet or in the form of undervaluation of assets. In most countries, and certainly in this country, these undisclosed reserves are considered to be part of the overall resources available to a bank to support the depositors and other creditors.

Another increasingly important aspect of capital is what may be referred to broadly as secondary capital or, in European Community parlance, the 'external' as opposed to the 'internal' elements of capital. These consist of various admissible capital market instruments under the general heading of subordinated debt. It is generally accepted to be capital of a lower quality than equity and free reserves but, in the view of many countries, it is regarded as a valuable adjunct to 'internal' or 'primary' capital, particularly because it is possible to denominate it in currencies other than the domestic currency of the bank concerned, notably in dollars, which form an increasingly important part of international banks' asset base. This helps achieve a better balance between the elements of capital and the currencies in which a bank's assets are denominated.

What I have been describing in trying to break down the various elements of the constituents of capital may be characterised as a tiered approach to identifying and measuring capital. This puts the elements of capital admitted within the capital base in different countries into some order of quality. This process enables different countries' constituents of capital to be applied to a common mould permitting comparisons to be made—a simple concept but not easy to apply in practice.

*. . . the quality of capital in the form of debt instruments*

One particular element to which we have been devoting considerable attention recently in this country has been the quality of capital in the form of debt instruments accepted within the capital base.

Over the last year or two we have become increasingly aware that the small print of loan capital documentation often contains trigger clauses that, in certain defined circumstances, provide for immediate redemption. Such trigger clauses were intended by those marketing these instruments as a minimum safeguard for the investor in the event that the bank defaulted on its obligations. However, these provisions are normally framed to cover any indebtedness by the bank and their effect, if triggered, could be to require early repayment of this element of capital just when it was most likely to be needed as a protection for depositors.

As a reaction to this trend, in proposals issued last autumn, we made it clear that subordinated debt of any type would not qualify as part of the capital base if there were any provisions in the loan agreement which triggered early repayment. This was not received with enthusiasm by the banks, particularly those in the business of creating and marketing these instruments, but I believe the Bank's position was widely accepted and, as the Governor remarked a few moments ago, we have been pleased to see that the prophets of gloom, who foretold that instruments carrying the Bank's conditions would be unmarketable, have been confounded.

A similar situation arose with regard to new instruments developed over the past year or so in the form of perpetual subordinated debt, ie debt with no final maturity. Again, with the composition of major banks' balance sheets in mind, the Bank has been receptive to efforts to create a form of instrument which, although perhaps not in every respect precisely the same as pure equity, was sufficiently close to equity in terms of the protection it afforded to depositors to rank *pari passu* with equity for capital adequacy measurement purposes.

Again, as the Governor mentioned, the Bank has been gratified to find that those who felt that instruments meeting our requirements would be unmarketable have not been right. An issue announced by one of our clearing banks last week, followed by a second major issue a few days later, have met the Bank's tests. The form was not precisely that outlined in our proposals but the basic criteria which lay behind the Bank's thinking were met. It does not represent, I should stress, in the Bank's view, any diminution in practice in the standards the Bank originally set out to achieve.

*. . . capital adequacy measures should be related to the overall risks . . . not just those on the balance sheet*

Reverting again briefly to overall capital measurement, it should be stressed that identifying the constituents of capital is only the first step in the process. That capital base then has to be applied in some appropriate way to the overall business of the bank. I say overall business deliberately, because banks may well be at risk for aspects of their business which are off the balance sheet as well as for those on it. This is the second major area of concern to which I would refer and which in my view makes it important that capital adequacy measures should be related to the overall risks which are present in a bank's business not just those on the balance sheet.

This line of thought has led many supervisors over recent years, particularly in Europe, to regard some form of risk asset ratio as a more useful and effective test of capital adequacy than a simple gearing ratio related to total non-capital liabilities or total assets. Under the former approach, categories of asset in a bank's balance sheet are given a weighting to reflect in some degree the risk which is perceived to be present in different kinds of asset. Thus, for example, commercial loans will generally be given a much higher weighting than an investment in domestic government obligations. This system of measurement also has the advantage that contingent liabilities can readily be brought into it.

*. . . and the supervisor must rely on judgement and experience*

No single capital adequacy measure, however, can incorporate the whole range of considerations which bear on the adequacy of a bank's capital to support its overall business. The supervisor will also need to consider the overall quality of the bank's portfolio of assets and take into account a range of factors—such as the type of security held against advances, the class of borrower, and analysis of country risk exposures—in making his overall judgement. There are also a number of less tangible considerations bearing on the relative importance of the role of the bank within the banking system, its profitability, its liquidity, the soundness of its management, and the reliability of its sources of additional capital. The risk assets measure itself is thus only one element of the process and the supervisor must rely on his own judgement and experience to apply crude figures to a particular context. Nevertheless the risk assets measure is a first stage, and a very important one in the wider assessment of a bank's capital adequacy.

But, following on from this, I do want to say a little more about another aspect of risk assessment which presents a special challenge in the current environment. That is the area of contingent risks and contingent liabilities. There are some traditional elements under this general heading, such as acceptances, guarantees, and performance bonds, where the risks are reasonably readily measurable. However, in the past year and more there have been developed a number of new instruments designed, in the main, to overcome the tighter capital constraints imposed by supervisors over recent years.

One such development has been the ceding of packages of usually high quality but low yielding assets from a bank's balance sheet to an independent finance vehicle. The attraction of this, for the ceding bank, is that it frees the balance sheet to take on new, possibly more remunerative, business which might otherwise have strained capital adequacy, while at the same time allowing the bank to benefit from fees received for managing the finance vehicles.

From the supervisory standpoint, asset management in this way can make for a more efficiently run business and usefully assist liquidity. But sometimes the ceding bank may also retain some residual exposure to the assets ceded by agreeing to participate in any future losses. It may be also considered to do so indirectly through its administration of the vehicle's portfolio or simply by lending its name to the venture in a way which gives comfort to the investors who are funding the vehicle. The supervisor has to consider carefully in each case the continuing contingent exposure of the ceding bank, and the extent to which it really has shed itself of all risk in respect of the assets sold. Furthermore, the supervisor should also be alive to the possibility that replacing what may be rather high quality assets ceded in this way with inferior quality assets can lead to a gradual erosion of the overall quality of a bank's balance sheet.

Other developments of off balance sheet risks have resulted from the scope offered by new technology to improve profitability. In particular, the strong growth in interest rate and currency swaps, and futures and options contracts would not have been possible without managements' reliance on the often complex computer programmes on which they are based. I am sure I am not alone in expressing the hope that senior management really is on top of the use made of these sophisticated techniques. Perhaps I may be excused for evidencing a little of the supervisors' twitch on this subject. Senior management and supervisors have to work hard to keep up with these developments.

*Contingent risk has now become a major item in banking business and needs direct control and supervision*

Another rapidly growing business has been the growth of long-term underwriting commitments undertaken as backing for rolling short-term paper programmes. In response to these developments the Bank considered it necessary, last month, to issue a notice to the banks applying what is for the moment a provisional risk weighting to this kind of business and I am hopeful that my colleagues in other major banking countries who are considering appropriate action in the context of their own systems may conclude that similar moves will be necessary.

At the same time, the Bank announced its intention to review, in consultation with the banks, the whole range of balance sheet risks to which they may be exposed in order to try and assess these more accurately in an overall assessment of capital adequacy. Contingent risk has now become a major item in banking business and needs direct control and supervision. Indeed, from discussions with the banks, it is clear that they sympathise with our concern and many of them already allocate a portion of their capital to cover some of the contingent risks which they carry which are not currently caught within our formal system of measurement.

*. . . the relationships of the supervisors with the auditors*

Another subject on which I would like to offer a brief comment is the relationships of the supervisors with the auditors. We, in the Bank, are actively considering this subject and the Institute of Chartered Accountants in this country has recently issued a paper expressing their views on this relationship. In countries where the supervisory function does not incorporate a system of inspection, as in the United Kingdom, the role of the auditor in performing the statutory audit can be a useful complement to the supervisor's work in contributing to the health and soundness of individual institutions and there may well be ways in which this relationship can be improved.

In Europe the system in Belgium, Holland and Switzerland is built around arrangements of varying degrees of formality for regular contacts between supervisors and bank auditors. The recent paper

produced by the accounting profession here points out that there are confidentiality constraints on both parties in promoting close contact but it suggests that these could be overcome—perhaps with legislative implications—if it were felt that more communication between auditors and supervisors was desirable.

The role of the auditor's letter to management is also an area to which further attention could be given. It may be that these letters could be developed not only to cover perceived weaknesses arising from the audit but also to be a means of providing confirmation that proper internal controls are in place and are being applied effectively and, in particular, that asset quality has been carefully and professionally assessed.

These then are a few of the issues which are current supervisory preoccupations and to which you will be coming back in the course of the next two days. We, in the Bank, will be very interested in the contributions and comments on these and other important topics which are down for discussion.

The mobile, inventive and adventurous state of banking today presents both the banks and the supervisors with a major challenge. Technological advances and competitive pressures have created a financial environment in which the banker is moving into new activities untested by adversity and thus without an historical basis on which to assess the risks involved. The reaction of the supervisor to these unknown risks must be a conservative one even though there is no desire on our part to stifle innovation in what has always been essentially a risk business.

*The securitisation of assets . . . has major implications*

Some of the innovations that I have been discussing have risk implications that go beyond the individual institution concerned to the whole financial framework in which banks have traditionally provided an intermediary function. The securitisation of assets referred to by the Governor has the potential to lead to far-reaching changes in the structure and conduct of traditional banking business. This process of turning banks' assets into marketable instruments which are then traded outside the banking system has major implications. It produces particular concerns for the supervisor but also raises much wider-ranging considerations of the effects of such disintermediation on the role of the banking system as a whole, how the wider financial market place can be properly controlled and how the regulatory processes can function effectively when the boundaries between banking and other financial activities are becoming more and more blurred.

These are problems for us, the supervisors, and problems for you, the bankers. We shall both need to pursue an active dialogue on many of these complex and important questions in the period ahead.