Convergence of capital standards and the lessons of the market crash

In a speech at the annual banquet of the Overseas Bankers' Club,[1] *the* ***Governor*** *discusses the progress made by banking supervisors towards international convergence of standards of capital adequacy and the importance of a sound analytical framework in bank provisioning against problem country loans. He goes on to consider some of the lessons of the stock market crash, emphasising in particular the importance of greater contact and co-ordination between securities and banking regulators, perhaps through a multilateral forum similar to the Cooke Committee.*

President Pöhl has referred to some of the lessons that may be drawn from the recent turbulence in the financial markets, and I too shall have something to say about that in a moment. But I would not wish to let this occasion pass without reference to the banking supervisors' convergence initiative. When I spoke here a year ago, the Anglo-American proposals on the measurement of capital were newly on the table, and I expressed the hope that they would find favour and stimulate further work on the convergence of capital standards—in particular that our Japanese and European colleagues would feel able to join with us in the creation of a multilateral framework. Very considerable progress has been made towards this end over the past twelve months, and now we have a set of proposals endorsed by the Committee of G10 Governors as a basis for consultation with international banks from the countries represented in that grouping. So we have already achieved a degree of consensus which, this time last year, many observers doubted was within our reach. To have moved so far and so fast is a considerable achievement.

The lead in this matter has been taken by the G10 countries, but I hope that others will follow once the outcome of the present consultations is known. We have, as you know, recently published our own country paper and we look forward to discussing with our banks here any concerns they may have. But it is important that we do not allow our efforts to reach agreement on a common measure to deflect us from bringing into the supervisory net, as soon as we can, banking activities whose risks are not currently measured. Off-balance-sheet transactions, for instance, continue to grow rapidly, but are still largely unsupervised. The events of the past year serve as a sharp reminder that new markets and instruments can contain imperfectly understood risks.

The convergence initiative has also greatly enhanced the status and authority of the Cooke Committee. I am reliably informed, as they say, that the discussions in the Committee were at times lively. Some compromises had to be made along the way, most notably in reconciling alternative definitions of capital, and in finding acceptable ways of reflecting other elements of strength in a bank's balance sheet, notably provisions or reserves against loans made to troubled debtor countries.

That we should have encountered difficulties in reaching these agreements is scarcely surprising given the very different positions from which we all started. Each of us had, at the outset, a fairly clear view that our existing concept of capital adequacy was not only the most appropriate to our individual national circumstances, but also the right one. In practical terms it would be extremely difficult to abandon those systems and move straight to a completely new one. The fact is that the new standard does *not* represent just the lowest common denominator, and we could not pretend that everyone would be able to meet it from the very start. It was for these reasons that the G10 group adopted a transitional period to allow a more gradual and measured move from where we are to where we wish to be.

Of course, there is more to equal competition than setting common capital standards. Differences in fiscal arrangements and, even more fundamentally, in the accounting conventions applying to banks in the various countries are just two of the factors which have to be taken into account. Nevertheless, I believe that we should, as supervisors, continue to try to promote a more equal competitive framework for international banking markets. And we should not forget that free and fair competition in banking markets is an important objective of the European Commission, as is evidenced by the new draft Second Co-ordination Directive. The initiative by the G10 Governors will I am sure provide a useful framework for further work on this proposal.

Provisioning

It has become almost traditional for me to say a few words at this time of year about bank provisioning against problem country debt; and I will not break with tradition in view of the topicality of the subject. This is a matter in

(1) On 1 February.

which there are considerable variations in terminology, accounting and tax practice as between the major centres; and where there can be marked differences in philosophy as between individual banks. In this country and in others there has been a trend recently to increase provisions against claims on heavily indebted countries. Within a proper analytical framework, this is very much to be welcomed, and we have sought to provide such a framework in this country in the form of a matrix to aid provisioning decisions by the banks. The matrix guided our attitude to the provisions charged by the British banks at the half year, and will, in a regularly updated form, continue to guide our judgements as to the adequacy of such provisions.

Of course in such an uncertain and changing environment there can be no uniquely correct view or precise calculation. But I hope that banks will continue to found their provisioning decisions on a sound analytical basis. There may be a risk, in my view, in the announcement by individual banks of levels of aggregate provisioning whose relationship to the true underlying risk in the loan portfolio appears tenuous. It would certainly be wrong if such exercises had more to do with creating a short-term impact on the bank's share price than with the long-term interests of shareholders; and it could at the same time send misleading signals to the debtors themselves.

I hope no one will interpret this as implying that the Bank has set its face against imaginative solutions to the debt problem. On the contrary, I very much welcome the way in which recent initiatives have widened the 'menu' of options for banks in deciding how best to manage their problem country exposures. It is surely right for banks and debtor countries to explore together different risk management solutions and for banks to review the attractiveness of these options in the light of their own particular circumstances.

Lessons of the market crash

President Pöhl has spoken this evening about the pace of innovation in financial markets, and the consequences of the recent events in world stock markets. It is still too early to assess the full impact of the turbulence of the last three months; one hesitates almost to risk declaring it passed! But I know that much work is already in hand to assess the implications both for supervisors of securities firms and banks, and for our ability to contain systemic problems as they emerge.

The sharp fall in equity values on world stock markets offers a clear demonstration of the possible risks for those banks which have pursued a strategy of diversification out of traditional banking markets into securities trading on a substantial scale. The growth of these markets, particularly here in London since Big Bang, has also brought a significant expansion in bank lending to securities companies, representing another dimension to the integration of financial markets.

One message that emerges from recent events is that, on the one hand, banks need to learn more about the activities of the securities companies to which they are committed as shareholders; and that, on the other hand, securities companies need to pay attention to some of the disciplines which have been received wisdom in the banking markets. For example, the risk of counterparty default in the broker community seems not to have been analysed or controlled with the same rigour as has long been the case for bankers, reflecting perhaps the culture gap that was discerned as banks and securities firms merged their operations ahead of the Big Bang.

It also became evident to us that while most banking groups active in market-making knew what was going on in their own home markets in the period immediately following 19 October, they were not so well equipped to know what their position was in the more far-flung markets. The lesson I draw from this is very simple: that for a major international bank active in several markets around the world it is just as important to know what your exposure is to a securities firm's Tokyo office as it is to their London office. Accordingly, I am sure that banks are right to be considering with some urgency the development of control systems capable of monitoring global credit and position risk exposures on a real-time basis.

Communication between banking and securities regulators

On Black Monday and immediately afterwards, it was both natural and necessary for there to be close and continuing contact between the two sets of regulators. Our immediate concern, as bank supervisors, was to find out what was going on in various markets, both at home and abroad, as quickly as we could. In order to keep up with events, we set up a working group bringing together supervisors from different parts of the Bank as well as from the Stock Exchange. In the first weeks after Black Monday, this group met two or three times weekly and was in daily contact with bank and securities market regulators in other financial centres around the world. The meetings of this group served as an essential information exchange at a critical point in time, and I believe the markets were comforted to know that we were keeping such a close eye on events.

More generally, in the weeks following 19 October, I perceived that there was a very high level of co-operation between banking supervisors and securities supervisors in many of the major centres, as well as between supervisors internationally.

The past year—and one can look back as far as the collapse of the perpetual FRN market more than a year ago—has also highlighted the systemic risks created by weakening liquidity in various securities markets. Events in several centres demonstrated the systemic implications of a failure to maintain a stable trading environment. We have also to ask whether some markets, particularly those directed to the control or redistribution of risk, may have been founded upon questionable assumptions about liquidity; and whether participants have allowed themselves too easily to suppose that the markets will allow them to avoid or dispose of risk in an orderly manner and at precisely the time of their choosing.

The financial soundness and integrity of the securities markets, and of participants in them, is of great importance to the international financial system. Capital adequacy of the securities industry is a matter for the securities supervisors. But banks are involved in this industry, either directly or indirectly, and the systemic implications are a matter for central banks, which have a key interest in the efforts of supervisors to minimise the threat. It is self-evident that securities businesses should not through their market operations and exposures be allowed to put the general system at undue risk. So while our interests are mainly systemic and prudential, we must take an interest in other aspects of securities regulation, especially those concerned with market structure, settlement and margins. It also means that we will need to look further at how best to develop contact between securities and bank regulators. While I would not wish to devalue the importance of bilateral contact in this matter, there is an obvious question about whether a multilateral forum, similar to the Cooke Committee, must not be necessary in the light of the events of last October.

Closer communication, through whatever channel, would encourage the co-ordination of different national approaches towards the monitoring and control of risks emanating from securities business. This objective makes sense for all G10 countries; and especially to those supervisors who, like ourselves, are faced with regulating in increasingly globalised markets. The idea of greater co-ordination between securities and banking regulators is far from new, but it is one that I find increasingly compelling as I ponder the lessons of October and the fruits of our experience with convergence.

In a further speech at the end of February,[1] *the* ***Governor*** *again considers some of the lessons to be learnt from the experience of the crash and its aftermath. He argues that, given the immense pressures at the time, the equity market's performance was very creditable and that immediate radical changes in the new market arrangements are unnecessary. But the episode does underline the need for regulators to pay the closest attention to capital adequacy and to identify the ways in which risks to the financial system as a whole can arise; and for firms operating in the markets to exercise close management control and discipline.*

The title of this conference—Post-crash Strategies for British Business—carries with it the strong implication that last October's market crash has in some way changed the landscape to such an extent that pre-crash strategies are now obsolete. I am not sure that this is the case. I can see no fundamental change that should have invalidated soundly-based corporate strategies pursued prior to the crash. For a few, however, the crash may have intensified a prior need to adapt or retrench. This has been particularly evident in the City, where low turnover since the crash has emphasised the need to rein in costs, built up in some cases on the back of unrealistic expectations about turnover and market share. For those who are slow to adjust there, I do not predict any particularly soft landing.

But elsewhere in the economy, there is little sense of any hard landing: or indeed, of any landing at all. The indicators tell us that output and demand immediately prior to the crash were much stronger than we had earlier thought; and they have continued strong in the ensuing months. Consumer demand still seems to be growing, and business confidence remains robust. Of course, international factors may modify this picture. Already there are signs of slightly less rapid demand growth in the United States. This is not unwelcome in the sense that it encourages hopes of a reduction in the US current account deficit and reduces the risk of renewed weakness in the dollar; but combined with sluggish demand growth in other major economies, it does emphasise the importance for UK producers of keeping a strict control over costs. This is perhaps not a new message, and I would have offered it before the crash with equal conviction: but it is important nonetheless, for while our recent price performance has been encouraging, trends in wage bargaining, against a background of slower growth in productivity, are less reassuring.

Industrialists will be concerned about the impact of market developments on their long-term financial plans and their relationships with the City. This is an important theme of today's conference; but I would like to confine myself now to some brief comments on the equity market.

While lower equity prices will undoubtedly affect the cost at which industrialists can raise funds by way of rights issues, in the sense that investors will place a lower value on past or prospective earnings, I would not judge that the City's ability to act as a source of equity finance has been significantly impaired by the crash. Similarly, while collateral values may be less than they were immediately before the crash, I do not see any serious reduction in the ability of companies to borrow. The market capitalisation of listed companies still stands well above its level of two years ago.

(1) At the NEDO/Economist conference on post-crash strategies for British business, on 29 February.

The primary market is underpinned by an efficient and liquid secondary market in equities. While the Big Bang was to a large extent concerned with the international competitiveness of London, a major aim was the development of new structures for trading domestic equities—to make these markets more open, efficient and liquid. I have no doubt that we achieved that; and I find it very encouraging that, without any artificial props, the trading system survived extremely well during the market decline in October. It succeeded, I would judge, in providing more liquidity, absorbing greater selling pressure and handling a larger volume of business during those critical few days than the old jobbing system would have done.

Inevitably there are those who say it could have done better; that telephones should have been answered quicker; that it was sometimes not possible to deal at the price on the screen. But given the immense pressures of the time, I find the market's performance very creditable. We cannot really expect the market makers to provide infinite liquidity in a sharply falling market; and fund managers cannot spend three months piling into equities and then expect to get out, in a single day, at the top of the market. In circumstances such as these there is bound to be some resistance, some widening of spreads.

It follows that I am not inclined to accept suggestions that we should be looking to change the systems introduced in the Big Bang, or to import arrangements of the kind proposed in some of the American reports on the crash. We need to think very carefully before endorsing artificial arrangements to smooth price movements or to suspend trading; they do not seem to me likely to promote either good order in the markets or the interests of investors. There are long-term improvements to be made—in the technology, in arrangements for handling small orders—but immediate radical change in our new market arrangements seems unnecessary.

But the events of last October do suggest some important lessons for the future, for regulators, for City firms—and perhaps for industry too.

Regulators, among others, have to take account of the possibility that securities prices may tend to be more volatile than in the past. This means that we need to pay the closest attention to the capital adequacy of market intermediaries, and especially those with large positions or client exposures.

It is also very important to identify the ways in which the system itself may add to the risks. For example, in the context of counterparty risk, as well as for other reasons, I have suggested a review of the Stock Exchange account system. I have been encouraged by the response, and I know that this is one of many aspects of the settlement system that the Stock Exchange is examining.

I have argued for better international co-operation between banking and securities supervisors. Markets are becoming increasingly interconnected; risk to the system can arise anywhere and be quickly transmitted to other markets. Consultations may need to be more formal; they certainly need to be more frequent. We made a start in a meeting a few weeks back between the Bank, the SIB, the Federal Reserve and the SEC; we shall be building on this.

But in this context it is important to remember that while central banks have a responsibility to ensure that sufficient liquidity is provided to the monetary system as a whole at times of strain, it is emphatically not part of their job to stand behind each individual intermediary, and any suggestion that it is, or should be, would in my judgement risk undermining the financial discipline on which the structure depends. Securities intermediaries obtain their external finance in the market and from the banking system; and while there are arrangements in many centres to compensate claimants on a failed intermediary, or collectively to guarantee the settlement system, these arrangements are generally of a mutual nature and are not underwritten by the monetary authorities.

As a central bank we have a close interest in these questions not only because of their implications for individual banks—for we have a duty to ensure that they have adequate capital—but also because of their relevance to the wider financial system. During the market crash in October we monitored very closely both general financial conditions and, in conjunction with securities supervisors, the position of individual securities houses. But I want to make it quite clear that in this area our interest lies in the avoidance of systemic risk, and it is because of the potential threat to the system rather than to its individual components that we attach such importance to the regulation of capital adequacy in the securities industry.

For the *City,* the crash and its immediate aftermath have focused attention on the close management control and discipline that needs to be exercised in many of the complex and ambitious new organisations that have emerged in the wake of the Big Bang. This is not just a matter of keeping control over costs—although this is important, as the recent period of low market activity has demonstrated; and the picture presented to the outside world by the City's hiring and firing practices is scarcely an attractive one. There is a need, too, for management to take a very close interest in the conduct of business within houses; the preservation of what, for want of a better expression, I have called the ethos of the City. The importance of doing so has been underlined in a number of cases over the past year; and management in our major houses must not underestimate the great damage to their reputation and standing that can flow from the appointment of inspectors to investigate possible contraventions of the law.

For *Industry,* I suggest that the most important lesson to draw from the market crash—as it was from some of the pressures that emerged during the industrial recession in the early 1980s—is the importance of relationships with providers of loan and equity finance. The sudden decline in the markets, both in securities and in derivative products, demonstrates very clearly the risks to all but the very largest companies of reliance on a transactions-based approach to finance—that is, selecting an intermediary or market package on a case-by-case basis, based on prices ruling at the time, and without any attempt to foster longer-term relationships with banks or investing institutions. This is of course a difficult area, capable of misunderstanding on both sides; and industrialists are quite right to take advantage of market opportunities as they arise. But the relationship is not to be measured just by the weight of money involved, or by the terms on which it may be provided. Of far greater importance are the ways in which financiers and industrialists work together in the longer term; and it is these arrangements that need attention if the relationship is to be a profitable one—for companies, for financial institutions, and for the country as a whole.