Recent developments in supervisory practice

In a wide-ranging survey, Brian Quinn—Executive Director, Financial Stability in the Bank—suggests[1] *that the recent coincidence of a much more competitive environment and a pronounced cycle in economic activity has played an influential part in supervisory developments.*

He argues that economic cycles tend to produce exaggerated swings in banks' profits; successful moderation of the cycle—by the early and judicious use of macroeconomic policy—might be the most important development in regulatory practice. Banks could in addition make their own contribution, by improving their risk analysis; and he sounds a note of warning against lenders rationalising away the lessons learnt in the recent cycle.

He also draws attention to the increase in financial criminal activity, and suggests that a recent UK innovation to improve the exchange of information among regulatory and criminal-prosecution authorities might serve as a model for wider international co-operation in this area.

Introduction

An examination of your programme over these last two days suggests to me that much of the ground which might be covered in any talk on recent developments in supervisory practice may already have been dealt with by others. I certainly would not want to place myself in head-to-head competition with the other speakers.

However, as some of you may be aware, the recent reorganisation of the Bank of England has left me occupying the position of Executive Director of the Financial Stability Wing in the new, restructured Bank—a somewhat risky and exposed position you might reasonably think. That role encourages me to look a little wider, and today gives me an opportunity to do just that.

Some of you may also know that I have been chairman of the supervisory sub-committee of the former Committee of EC Governors (latterly the Council of the EMI) for these last five years. This enables me to look beyond the United Kingdom so far as the banking sector itself is concerned. However, I would wish to stress that any views I offer today are entirely my own.

Finally, as the United Kingdom and some European countries emerge from what was a particularly difficult economic cycle, it might be interesting to spend a little time talking about what that experience may have taught us. The connection between developments in the economy in general and the performance of banks has seldom been clearer, and prompts some thoughts on the implications of the current and prospective stance of macroeconomic policy in a number of countries. There are grounds for both encouragement and for concern in what I think I see.

Recent developments in the real and financial economy

The last few years have witnessed a powerful combination of forces leading to strains in the banking sector and in financial markets generally.

There seems to have been no let-up in the developments in technology which allow financial institutions to come forward with new and increasingly complex products. The conduct of merger and takeover bids—to take just one example—has been transformed by the imaginative use of derivative instruments; and, of course, the players in capital markets have expanded to cover a much wider range of financial and non-financial institutions. These markets have, as a result, become wider; whether they have become deeper is, however, another matter.

On the other side of the market, the consumers of financial goods and services are enjoying probably unparalleled benefits in the variety and sophistication of what is available. As a quick glance at the daily newspapers will confirm, retail customers as well as wholesale have a much wider choice of products. The liberalisation of financial markets and banking systems has also meant that access to these sectors is probably freer than ever before. Taken together, these factors have generated a distinct change of gear in competition, with a general downward effect on the prices and margins available to the manufacturers and distributors of financial goods and services. This much is well recognised and has been the subject of much comment.

A further factor has been an economic cycle the length and amplitude of which has in many countries been greater than in any period since the last World War. In the upswing of

(1) In a speech at the Financial Times' conference on international banking in Madrid on 30 September.

this cycle, economic conditions existed which encouraged banks and other financial institutions to deploy the new technology and their enhanced marketing skills to maximum effect. The feel-good factor among borrowers, personal and corporate, was more than matched by the keenness of existing and new participants in the financial sector to capture market share. Part of the perceived wisdom of the time was that deregulation would result in a relatively small number of very strong financial institutions which would gobble up, or wipe out, the opposition. No-one could afford to be left behind in such a climate. There was particular enthusiasm for capturing the new entrepreneurs, the small and medium companies that were established in this period of optimism.

As margins in commercial lending came under increasing competitive pressure, banks sought to maintain earnings by shifting capacity in other directions—notably into trading activities, especially in foreign exchange and capital markets. Non-banking institutions, particularly but not exclusively securities companies, had at about the same time identified securities trading as an attractive source of income. This was intended to replace their traditional revenue streams, which were themselves rendered less sustainable by the abolition of fixed commissions and the growth of competition in this sector. There was, in a word, convergence by both banks and non-bank financial companies on designing and trading financial products. In this environment, it now seems quite unsurprising that derivatives should have expanded at the pace which we have observed in the last decade.

Much has been said and written on the subject of derivatives: the reservations and concerns of supervisors do not need repeating by me. Nevertheless, the Bank of England is among those ready to acknowledge that these products also have the potential to make markets more efficient, and to bring financial and welfare gains to both those who supply and those who use them. They have also had important spin-offs, the most important of which—from a regulator's viewpoint—is a much more detailed understanding of risk. Derivatives in particular have stimulated work on the analysis and pricing of risk. The results of this work are capable of being applied to credit risk as well as to the various classes of market risk. I will leave to Gene Ludwig(1) the task of speaking in greater depth about the challenge to supervisors of dealing with derivatives and concentrate instead for a moment on the particular subject of credit risk.

The experience of recent years has demonstrated yet again—as if it were necessary to do so—that banks' understanding of credit risk has been, to put it politely, somewhat imperfect. The EMI supervisory sub-committee recently embarked on a study of evolving conditions in the banking sector in EU countries over a period of years, the first stage of which indicated clearly that credit problems were by far the most important factor leading to difficulties among member banks. The work also demonstrated that the downward trend in lending margins, so evident in US and UK commercial banking sector in the last five years, is being repeated in a large number of European countries. Furthermore, the incidence of bad and doubtful debts—which in the recent recession were in some countries at a level unprecedented since the war—strongly suggests that bankers in several countries had allowed the risk/reward ratio to get seriously out of kilter. Risk management manuals seem to have been left to gather dust in too many cases where the pressure of competition from both inside and outside the sector appeared to threaten the loss of critical customer mass.

The supervisory response

Against this background it is not, I think, too self-serving for banking supervisors in G10 and EU countries to claim that the steps they took to increase capital standards among banks were timely. I might also note in an aside that later suggestions that these higher standards would lead to a credit crunch which would stifle the recovery from recession have been falsified by continuing low demand for credit and ample bank capital. However, it would be quite wrong for the supervisors to think that they were as a result spared the need to look hard again at the analysis of credit risk and to assess the implications for banks' pricing and provisioning policies.

Supervisors are making serious efforts to stay abreast of developments in risk management more generally. The adoption of complicated, mathematically defined risk models has posed new challenges, to which we are having to respond by specialisation of staff very similar to that which is taking place in banks and other financial services companies.

The Bank of England has established a small, expert traded-markets team whose working time is devoted exclusively to understanding the models employed by the major financial companies to determine the pricing of their products and the capital required to support the risks involved. The Basle Committee is approaching the question of market risk in the same way and has these past months been looking, through a similar group of experts, at the models and techniques used by firms throughout the G10. We are now in the process of testing these models and the results could be important input to the choice of capital adequacy requirements which the G10 supervisors will propose in their current work on market risk.

Work of this kind inevitably takes a supervisor not only into increasingly greater detail both as regards the particular parameters and variables in these models, but also into further and further refinement of approach. Where should this end? I accept that moves along limited sectors of a particular yield curve can produce differences in risk. But does it really matter all that much?

There is a feeling of *déjà vu* in saying this. The original Basle capital accord was, you may remember, criticised for

(1) Mr Ludwig, the Comptroller of the Currency at the US Office of the Comptroller of the Currency, also addressed the conference.

its excessive simplicity. We have never sought to argue that that approach was anything other than broad-brush in its analysis of risk. But it was easily comprehensible, capable of leading to straightforward and relatively inexpensive reporting requirements and broadly right—not a bad package in my view.

There is clearly a trade-off between accuracy in detail and cost, and I am by no means persuaded that the right approach is to follow the analysis of market risk into finer and finer gradations so that the regulatory regime captures every risk variation. It is surely right that supervisors should understand as well as they possibly can what risk models mean; but I have long believed that having understood that, the supervisor should be wary of being drawn into fine judgments between counterparties or classes of instrument. That is for the banker and securities company; otherwise business decisions may be excessively influenced by regulatory requirements. There is also the risk that such an approach may result in being unable to see the wood for the trees.

All of this seems to me to point to two broad conclusions: first, that we should have in our minds the whole-bank, or portfolio, approach in looking at an institution's risk profile; and that we should be trying to identify the main parameters or determinants of risk in proprietary models, and to concentrate on these in order to keep our approach broadly right. This is perhaps as level a playing-field as we should be aiming for. It would be dangerous if we were to believe that market risk—any more than credit risk—could be reduced to a series of equations and coefficients. Important as these features are, and vital as it may be for supervisors to understand them fully, decisions are ultimately a matter of judgment exercised by management; hence the importance attached by supervisors and regulators to the qualitative aspects of risk management.

Economic cycles and bank problems

I argued earlier that the coincidence of a deregulated, much more highly competitive environment and a pronounced cycle in economic activity can spell trouble for financial institutions and particularly for banks. It is by now received wisdom that during the upswing—and particularly when asset values are rising quickly—bad credit and bad market decisions tend to be obscured; and in a severe and protracted downswing, a reversal in the circumstances not only reveals those errors of judgment but can also create solvency problems for institutions which may have behaved in a way that could be considered prudent in normal circumstances.

Such was certainly the experience in the United Kingdom in the downswing of the cycle in the years 1990–92. A significant number of small banking institutions in particular saw what were initially temporary problems of liquidity gradually turn into problems of asset quality, as the recession hit particular sectors of the economy especially hard and stretched out over an unprecedentedly long period. This experience corroborated work done in the Bank suggesting that cycles in the economy have been generating increasingly pronounced cycles in bank profits.

A principal factor at work here is the timing difference between the reporting of income from a bank loan and the provisions which subsequently have to be raised when the same asset becomes impaired. This coincides with the interruption in the revenue stream when the asset moves from performing to non-performing. A further distortion arises from the boost given to nominal income during the inflationary phase of the cycle from the deployment of shareholders' funds.

Ironing out these distortions not only dampens the amplitude of the swings in bank profits but—when corrected for inflation—shows a fairly stable real pre-tax rate of return on equity in the mid-teens, with even the suggestion of a slight upward trend. Of course, it does not necessarily follow that these unadjusted movements in profits are generated only by the cycle—bad credit decisions would create these swings in reported profits even in stable conditions—but the data make it quite clear that these decisions are at least coincident with the movement of the economic cycle and probably caused partly by it.

The results of this work do not, on the face of it, support the view, widely held, that there is excess capacity in some absolute sense in the UK banking sector—at least among the largest banks. It may, however, be that in the face of excess capacity banks have shifted the use they make of this capacity into the manufacture and distribution of other financial services, thus maintaining real profitability. This tallies with the diversification of UK commercial banks into housing finance, investment and insurance products, where a branch network and a capacity to process bulk transactions is valuable.

Over the period covered by this work, encompassing two complete cycles in economic activity, the number of small banks and financial institutions has steadily reduced. Some 60 have gone out of business, or merged, or been absorbed by others. Of course, a number of other powerful forces have been at work leading to concentration in the financial services sector. For example, the larger banks may have moved into the sectors previously served by the smaller banks, both to make use of their spare 'soft' capacity and in response to increased competition in their own customer bases. But there is at least a question as to whether the process of consolidation has been hastened by the cycle. As I indicated earlier, smaller banks—particularly those dependent on wholesale funding—saw what started as a liquidity squeeze change into solvency problems during the last recession, and it is possible that some of these institutions, which serve the needs of particular sections of the business communities, may have been driven out of business unnecessarily or prematurely.

It is also worthwhile asking ourselves whether the macroeconomic policy mix could have been another factor influencing the performance of the financial institutions.

The relative roles played by fiscal and monetary measures in the conduct of macroeconomic policy also appear to have changed over a number of years. In particular, fiscal policy appears to have been carrying less of the burden than monetary policy in the management of the economy. There are several reasons for this, including: the difficulties of making timely changes in the fiscal stance, given the political difficulties and parliamentary procedures involved; the fall from fashion of budgetary adjustments as a means of fine-tuning economic activity in these circumstances; and the prevailing counterinflationary thrust of macroeconomic policy in recent years. In these circumstances, changes in short-term interest rates have carried more and more of the weight in the policy mix.

The question here is whether changes in short-term interest rates, sometimes of an unexpected magnitude, have produced larger variations in the value of financial assets than would have been the case if fiscal and monetary policies were making a more equal contribution to the adjustment process. Such general questions, of course, need much more thorough examination. The ingredients of a change in fiscal policy can clearly affect particular classes of asset with special force; one would also have to look at the changes in the portfolios of banks' assets over a period of years to see whether they were becoming more or less susceptible to changes in short-term interest rates.

But intuitively it seems plausible that the use of an instrument which is explicitly counterinflationary in its purpose should have a more direct and more substantial effect on the value of financial assets than changes in general taxation or expenditure. This would be especially likely if the changes in interest rates were an unexpected or delayed response to developing problems in the economy.

Some tentative lessons

Let me try to draw out some tentative conclusions from these observations for banks and financial regulators.

First, economic cycles are bad for your health. They tend to produce exaggerated swings in bank profits and, through their effects on credit judgments, generate uncertainties about the value of bank assets which must find reflection in the capital markets' valuations of banks' shares. Moderation in the economic cycle, particularly if combined with a general low inflationary environment, should substantially reduce the differences between banks' reported performance and their underlying performance. This could lead to a lower real cost of capital.

Banks can make their own contribution to any such development by improving their risk analysis—both as it bears on credit risk but also in the area of market risk, given the change in the composition of bank activities. They should also be giving consideration to provisioning policy with a view to smoothing out the differences between reported and actual profits over the life of the loan book; or, alternatively, taking account of these timing differences in setting their own capital ratios for operating or budgetary purposes. Bank supervisors should take this into account in judging whether banks are making an adequate provision for loss and have adequate capital.

A mix of macroeconomic policy which achieves broad balance between fiscal and monetary policy could also make it easier for banks to achieve greater stability in bank earnings. Changes in short-term interest rates that anticipate, rather than lag, the performance of the economy could also contribute to a reduction in the amplitude of the cycle and a more even pattern of bank earnings.

A lower real cost of capital for banks, combined with the use of techniques which enable risk to be reflected better in the pricing of banks' goods and services, should in the long term enhance their capacity to compete more effectively with non-banks.

Such a scenario paints a rather attractive picture and one which goes against what I perceive is a degree of gloom concerning the long-term prospects of commercial banks. If it is not exactly the sunlit uplands, it at least suggests that bankers are not necessarily marching into the Valley of Death! But it is, of course, both naive and unrealistic to think that the rest of the world will stand watching while banks take advantage of any such improvement in the economic environment. Secondly, I regret to say that I feel I cannot assume that banks will not find other ways of digging holes for themselves. As I have already indicated, the supervisors of both banks and securities companies continue to watch developments in derivatives with close interest, and are not prepared to take on trust assertions that market risk models provide adequate insulation against unexpected and significant loss. Models are only as good as the modellers—and modellers are not infallible.

Nor can it be assumed that banks will not dig the same hole for themselves as they have in the past. While it may be true that the significant changes in economic conditions in recent years may have overwhelmed even normally prudent lending behaviour, it is hard to escape the feeling that the banks themselves failed to observe the necessary disciplines in their lending operations.

Indeed there are already some signs in the United Kingdom that the lessons of the recent cycle may be being forgotten. In conditions where the demand for credit is still very slack and where banks have ample capital to support the expansion of their balance sheets, there are signs that margins on any new credits being arranged are now very fine. Perhaps even more disturbing, the conditions on loan covenants are being relaxed for these credits.

One has to be careful of overreacting to these signs. It may be that the banks' risk analysis has already improved to the point where the pricing of credits, especially to high quality borrowers, makes good prudential sense. There was also criticism of the commercial banks for relying excessively on security, so it is also possible that the non-price terms and conditions attaching to credits have been relaxed for good reason reflecting the quality of the borrower. But you will

understand if I remain to be persuaded by such arguments. I am rather more inclined to suggest that the lessons of the recent cycle may already be being rationalised away.

The prevention of crime in the financial system

Another threat to the world's banking system, and one which does not at first sight appear to be close to the interests of supervisors and regulators, is the growing use of the financial system by criminals.

It is, of course, true that banking supervisors and financial regulators have been directly involved in efforts to keep the launderers of the proceeds of drugs and other serious crimes out of the financial system. The Basle Committee of Supervisors in 1988 issued guidelines designed to assist banks in detecting the laundering of drug money. These guidelines have since been incorporated into reporting procedures in G10 member countries. But the evidence grows that criminal activity of other kinds—including most notably fraud—is showing up more commonly in the financial institutions of the developed countries. Part of this increase involves financial institutions in countries where the systems of regulation and supervision have only recently been established and do not yet incorporate the safeguards found in the developed world.

But it also has to be said that criminals in the more developed countries seem to have concentrated their attention in recent years on either defrauding authorised financial institutions, or using these institutions to perpetrate fraud or other crimes on third parties. Such a development, it seems to me, could become every bit as damaging to the world financial system as imprudent behaviour of the kind that led to the formation of the Basle Committee.

The establishment and work of the Special Investigations Unit of the Bank of England strongly suggests that such behaviour is on the increase; and one hears similar stories from a number of other countries. The UK authorities have responded to this by the formation of the Financial Fraud Information Network (FFIN), which combines not only representatives of the supervisory and regulatory bodies in the United Kingdom, but also of the police authorities and other official agencies involved in the detection and prosecution of crime. This body—which is chaired by the head of the Bank of England's Special Investigations Unit—has been in existence now for almost two years, and has led to enhanced information flows between those represented and to a number of cases where co-operation among these agencies has been effective in preventing or pursuing criminal activities in the United Kingdom.

I am not aware that a similar arrangement exists in other countries, and I do wonder whether there might be scope not only for national models of this kind but also for international co-operation which could be founded on the work of bodies like FFIN in the United Kingdom. The precise form of the model would, of course, be a matter for the national authorities in each case, but I feel that it must be possible to combine variety in national arrangements with more effective co-operation between regulators, supervisors and the criminal-prosecuting authorities in a number of countries.

European regulatory developments

Much time and energy is being spent at present by European banks, securities companies and regulators in preparing for the implementation of the Capital Adequacy Directive (CAD) which—with its companion Investment Services Directive—represents a major element in the programme of Single Market legislation.

I do not think it is appreciated how complicated and far-reaching the introduction of the CAD will be. It should do more to achieve a consistent prudential framework for the securities and foreign exchange operations of financial institutions than any other single measure; it provides a conceptually level playing-field. I say 'conceptually' because there will doubtless be national variations in how the Directive is implemented and, in particular, in the extent to which the CAD is seen not only as a minimum but also as a norm. It would be regrettable and contrary to the spirit of the Directive if the opportunity was not taken to do some equalising of the capital standards with which European banks and securities companies have to comply. But that still leaves scope for legitimate differentials not only between countries but also within countries. I do not think it follows at all that capital requirements above the CAD minimum in a single country or in a given activity necessarily bring a competitive disadvantage. One simply has to look at the rating agencies' rankings—and the resulting funding costs—to make the point.

The CAD also contains a provision for amendment which could allow supervisors to take account of progress made in the deliberations of the Basle Committee of Supervisors in the same areas. The task here is for the Basle Committee to make progress with its own proposals sufficiently quickly to enable them to be taken into account before banks and securities companies have to commit the significant resources which will be needed to comply with the CAD itself. I hope that this can be done. I hope too—but am less confident—that the securities supervisors can resolve their own internal differences, so that the common framework being sought in Europe is identical with, or at least consistent with, that being adopted in the other main financial centres. The banking and securities supervisors had a near-miss on this subject over two years ago. Perhaps enough time has elapsed since then to hope that that near-miss can be converted into a docking operation, if I may mix my aerospatial metaphors.

Payments and settlements

I should not fail in any talk addressing recent regulatory developments to note the progress being made in reinforcing payments and settlements systems in a number of countries.

Payments regulators in the European Union are already well advanced on work designed to produce payment

arrangements across the European Union that are fully compatible with the conduct of a single monetary policy and, ultimately, a single currency. Much work is also going on among the G10 payments experts on multilateral payments developments. Finally, settlement arrangements in equity and bond markets in London are being substantially overhauled to reduce the risk of operational failure in these markets. I am aware that this is not the sexiest of subjects, and know of at least one chairman of a large bank who congratulated himself on having completed a career in banking without allowing himself to be drawn into payments matters. No such luxury is afforded to bank chairmen these days.

Conclusion

It is not the job of the supervisor or regulator to seek to eliminate losses or failure in financial institutions. To try to do so would be not only to court certain failure but would be wrong in principle. As I see it, it is our job to identify and, where possible, measure risks; to put in place a framework that provides a degree of protection to investors and depositors; and to satisfy ourselves that the managers of financial institutions are aware of the risks in their business and have put in place arrangements to control them.

Doing this job is, I can assure you, quite demanding enough. Current and recent changes in the financial system mean that the precise nature of the challenge can change without much warning. We are told—and I believe correctly—that the underlying risks themselves have not changed, only the form. That is, however, of limited comfort. This means the vehicle of the risk can be all-important, and supervisors and regulators, I have tried to argue this afternoon, must make every effort to stay up with the game. Technological developments, in particular, present an ever-changing challenge—whether one is talking about financial risk or about criminal activity in the banking system.

But there is another, probably more important, force at work which regulators and supervisors have little power to influence, and that is the economic environment in which financial agents of all kinds carry out their business. If the economic cycle could be moderated through the early and judicious use of macroeconomic policy, this could be the single most important development in regulatory practice. It may sound strange to say so, but recent changes in short-term interest rates before the economies in several countries have entered a new boom phase might possibly mark a change in the longer-term fortunes of banks, securities companies and those who use their products.