BANK OF ENGLAND

Speech

Risk Sensitivity and the New Basel Accord

Speech given by

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Introduction

It is a great pleasure for me to be adding my remarks today to those of Bill McDonough and Howard Davies. I would first like to congratulate Bill, as chairman of the Basel Committee, on the very real achievement that this new capital framework represents. Products that are 'designed by committee' normally come in for some fairly trenchant criticism, but this one represents a new milestone in financial regulation, one which I believe will strongly influence how all financial firms, not just banks, come to be regulated in the future. I know it has been a lot of hard work, and I don't just mean the shoulder-strain involved in carrying the document onto airplanes! Unfortunately the hard work is not over yet, both for the authorities and for the banking community - even looking beyond finalisation of these proposals, supervisors and banks will of course have to see through a long and complex implementation process. But this is not to underestimate the progress that has been made and it is certainly a good moment to take stock of the proposals as they stand.

Although underpinned by the straightforward proposition that capital requirements should be more sensitive to risk, the new Basel proposals are frequently referred to as a 'package'. I would describe the components as, first, some very difficult technical thinking, which has addressed questions regarding the purpose of capital that were barely even thought of back in 1988. The second component is, unsurprisingly, pragmatic compromise. The result is, I think, a reasonably coherent whole; I know that those involved have tried to think about the sum of the parts as well as the individual parts. And it is this question of the overall, long-term impact of the new Accord that I would like to focus on today. The Bank of England has as two of its three core purposes maintaining the stability of the financial system and seeking to ensure the effectiveness of UK financial services. Both are relevant to the discussion of capital adequacy. The Bank, participating in the discussion of the New Accord as a member of the Basel Supervisors Committee, has looked at the proposals, not only from the perspective of financial stability but also with regard to the efficiency of the banking system.

My intention this morning is to start by discussing how the principle of risk sensitivity has been translated into the New Accord. I want them to consider the question of whether the proposals have in some cases achieved too little risk sensitivity and the implications of this for the level of risk capital in the system. I would then like to turn to the opposite question: whether in some circumstances the new proposals will achieve too much risk sensitivity, and to discuss this question in the context of the debate about whether internal ratings will amplify procyclicality. I shall also say something about the implications of this for lending to small and medium-sized companies. Finally I would like to end by saying a few words about forward-looking provisioning and liquidity. These are, to my mind, important adjuncts to the regulation of capital and it is important that they are not overlooked in the current focus on capital adequacy.

Risk Sensitivity in the New Accord

The common theme behind the revisions to the Basel Accord is greater risk sensitivity. This is a move we strongly support; risk insensitive capital requirements lead to some very perverse incentives and have contributed to a number of real-world problems. This has been less the case in this country , where of course the FSA supplements the crude minimum Basel requirement with tailored capital ratios, than in some other countries, but we have not been immune even in the UK. Certainly I wonder if over-investment in highly-speculative real estate development, a common precursor to a number of banking crises, would have been quite so prevalent if capital requirements had better reflected the often-volatile nature of such lending. And many commentators have expressed worry about the possible role that the current, uniformly rather low, capital requirements for short-term interbank lending played in the massive build up of capital flows to Asian countries prior to the 1997/98 crisis.

In several developed countries, of course, the risk insensitivity of the capital requirements has led to a whole industry of capital arbitrage, which has swelled to enormous proportions over the past 10 years or so. It has been estimated that by March 1998, non-mortgage securitisations by the 10 largest US bank holding companies amounted to around $200bn, or more than 25% of these banks' risk-weighted loans. A combination of conscientious supervisors, market discipline and relatively benign economic conditions for much of the past decade has, of course, meant that such arbitrage has not so far led to any major problems in developed countries, but the issue is not one that the authorities can afford to ignore. Ultimately, capital arbitrage and capital requirements that do not capture accurately the risks that banks are actually running mean that we risk tolerating unsound banks and jeopardising financial stability.

Getting the Level of Capital Requirements Right

So the move to introduce greater risk sensitivity is right. But determining the optimum level of risk sensitivity for a common set of rules intended to apply to banks in a wide range of different markets, countries and businesses is more difficult. And so there are two questions I want to go on to explore. First, have the proposals achieved enough risk sensitivity? And second, do they achieve too much risk sensitivity, particularly in the context of the debate about whether ratings amplify procyclicality?

As I said earlier, the new Accord has been designed to incorporate some real-world pragmatism. A major achievement of the existing 1988 Accord, and one that we would like to see preserved, has been its near-universal worldwide acceptance as the minimum standard for banking stability. So, if this huge advantage is not to be lost, it means that the new Accord has to be adaptable to a wide range of situations, to accommodate not only differing levels of sophistication amongst banks but also differing levels of expertise amongst supervisors. The answer, unsurprisingly, is a menu approach. For credit risk, alongside the greatly more risk sensitive internal ratings based approach, we have the option of a revised standard approach. This is certainly a step forward from the existing approach, but it remains a relatively simple framework. In its implementation, for many banks it may prove very simple indeed, since the large bulk of their loans are likely to have no ratings and so fall into the unrated bucket. The result will be little change on the existing Accord.

I think this is inevitable. Whilst I would hope that all banks have some form of internal ratings system, and whilst the Committee's proposals are intended to offer incentives to banks to upgrade their systems to the Committee's standard for recognition, banks cannot be forced to adopt loan ratings systems that conform to the Committee's criteria, and nor is there an unlimited global supply of supervisors capable of monitoring such systems. In the absence of external ratings - which the Committee is not in the business of promoting - there has to be a simple uniform weighting on unrated credits. While this outcome may be inevitable, we do need to think carefully about the possible consequences. First, given that we have to have a simple alternative to the internal ratings approach, it is important that the new Accord provides the right degree of capital incentive for banks to progress over time to using internal ratings. It is the Committee's firm intention to ensure that the final Accord provides modest incentives for banks to adopt the internal ratings approach. There is a conservative bias in the standard approach; and internal ratings in measuring risks more accurately should, for lower risk business, result on balance in lower capital requirements.

The objective of ensuring some capital incentive for banks to progress to risk sensitive measurement does, of course, have 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. This, along with a large number of other questions about the impact of the proposals, will be further examined by the Committee in the course of a quantitative impact study to be carried out before finalising the proposals. The Bank of England has been asked to co-ordinate this work calibrating the impact of the new Accord on individual institutions and on the system as a whole. I recognise that the time allowed for this exercise is short, but I hope very much that we can count on the contribution and co-operation of the banking community.

Turning to the second possible consequence of maintaining a risk insensitive alternative approach, we may find that the combination of having some banks on the IRB approach and some on the standard approach will, perversely, introduce a financial stability risk that is not present with all banks on the standard approach. This is that the more sophisticated institutions would have to hold more regulatory capital against weak loans than banks that remain on the standard approach. Over time, therefore, we could find that the worst-quality credits could gravitate to those banks which are the least able to assess, price or monitor them. However, I do not wish to suggest such a scenario without also highlighting how we may guard against it.

First, of course, the role of Pillar 2 - individual assessment of banks by supervisors with appropriate action to follow - will be extremely important in ensuring that all banks, not just those on the internal ratings approach, have a level of capital appropriate to their risks. Secondly, the Committee has clearly emphasised that the standard 100% risk weight for unrated credits represents a floor. Supervisors are encouraged to increase this risk weight when warranted by the overall default experience in their jurisdiction and for the particular bank concerned for their unrated exposures. And I hope, taking a prudent approach, that the supervisors will do this. Even with the current Accord, there are a number of countries, the UK included, that have applied capital requirements in excess of the minimum risk weights in the Accord and this does not appear to have made their banking systems uncompetitive internationally.

Where supervisors do not currently have the types of data that would enable them to form a judgement on the appropriate risk weight for unrated credits, I hope that the disclosure requirements in Pillar 3 of the new Accord will help them. Corporate bankruptcy rates, bank provisioning and write off experience, bond yields and default experience, together with data from any banks that are on internal ratings, could all be used to help the authorities form a view of typical or average credit risk for bank portfolios in their countries. This sort of overall, aggregate monitoring of the adequacy of the standard risk weights will be particularly important for developing countries who may initially face some resource constraints in implementing Pillar 2. It should result in an overall adjustment of the weight on unrated exposures, if risks appear to be higher than the capital set aside to back them. This would need to be reinforced by supervisors assessing for all their standard-approach banks individually whether their write-off rate is compatible with the 'standard' 100% capital weight, or whether a higher figure is needed.

Credit Risk Mitigation

So there may be elements in the new Accord that achieve too little risk sensitivity but I think this was unavoidable and, with Pillars 2 and 3 of the Accord, supervisors have the scope to see that they do not give rise to problems. However, I do not want to leave this question before touching on one more issue. This is the extent of the recognition of credit risk mitigation techniques. The new risk sensitive framework goes much further than the introduction of internal ratings - another area of greatly increased risk sensitivity is the new regime for credit risk mitigation. Again, the Committee's proposals here represent a considered and careful balance. On the one hand, the objective has been to provide in the new Accord a significant expansion, within a menu approach, to the recognition of collateral, credit derivatives and guarantees. But this is balanced on the other hand by specifying legal and operational standards that must be met before relief is granted and setting capital requirements against residual risks. This may - indeed is intended to - lead to much greater incentives to acquire good quality collateral and other credit insurance. This will be positive, provided the necessary operational standards including legal robustness are observed, and provided, as I said on another recent occasion, that the processes, volumes, and end results of transfers of credit risk are reasonably transparent.
I am aware, however, that some initial comment from the banking industry is that the Committee has not afforded enough recognition to physical collateral, particularly under the standard and 'foundation IRB' approaches. In this respect they think the Committee achieved too little risk sensitivity. The idea of a consultation paper is to elicit comment, but there are problems with the recognition of physical collateral that need to be considered. One is the difficulty of pinpointing accurate valuations for such collateral - much of it does not have anything by way of a valuation history. And values for physical collateral are also likely to be cyclical. When manufacturing companies are in recession, the values of related assets - plant and machinery or inventories - are likely to suffer too. Before regulators recognise more physical collateral, the banking industry needs to come forward with ideas on how to solve this problem.

Procyclicality of Capital Requirements

I want now to turn to my second question; whether we might in some sense be introducing too much risk sensitivity. Under this heading the issue I want to discuss is the danger of 'procyclicality', that is the possibility that regulatory capital requirements will reinforce cyclical movements in the macroeconomy. There was some element of that in the original Accord - because in a downturn specific provisions and write-offs increase, which reduces banks' capital, and may diminish their appetite to make new loans. However, under the new Accord this will be reinforced by the possibility that, as the condition of borrowers deteriorates during an economic downturn, they will be downgraded by banks with the consequence that extra capital has to be set aside. On some estimates, bank capital requirements could as much as double during a cyclical downturn.

This is clearly an issue of major concern to central banks. The risk is not a theoretical one; there is evidence that external ratings to some degree behave procyclically, while banks' internal ratings are liable to be even more so. Clearly here again a balance has to be struck between our desire to have the new framework incorporate and reflect current practice at banks, and ensuring that these current practices do not lead to economic volatility. The Committee's statement that ratings should not be 'point in time' but 'must represent a conservative view of a long run average probability of default for the borrower grades' attempts to introduce such a balance. Such ratings ought to be reasonably robust to the normal ups and downs of economic activity. The Committee has backed this up with requirements for minimum lengths of data histories to underlie the internal ratings, so helping to ensure that they incorporate some experience of economic low points. Over-optimism by banks in allocating ratings could also induce procyclicality. The Committee proposes several checks on this. In particular, supervisors will look at the ratings allocated to some individual loans, and also compare the distribution of loans across rating bands with those of different banks. Ultimately, of course, we will have to rely on those charged with daily supervision of banks, backed up by the Pillar 3 disclosure requirements, to ensure that ratings are not set in a way which risks undue procyclicality.

Impact of the Basel Accord on SMEs

Leaving aside the issue of how the risk sensitive capital requirements will behave over an economic cycle, I would also like to touch on the question of how they may affect the supply and pricing of finance to certain types of borrower. If risk sensitivity means a greater distinction between different types of borrower, we need to consider carefully whether the right outcome has been achieved. A specific concern, which I know has occupied a number of members of the Basel committee, is how small and medium sized enterprises might be affected, given their importance to economic activity and their reliance on bank finance. It is not yet clear how the proposed new Accord would affect the pricing of finance for SMEs. Many factors are relevant, including whether banks are on the standard or IRB approaches, what types of collateral or guarantees SMEs can offer, whether the borrowers are classed as part of the retail portfolio (as very small enterprises will be), whether the regulator sets the bank's overall target capital ratio (which in the UK is set individually for banks) and how much excess capital the bank has over that. It seem likely that in the UK at least the overall result for many SMEs will be 'no change', not least because banks' economic capital and pricing is often already risk-adjusted. But I know that a number of major British banks are concerned about the impact on SMEs, and the Bank is working closely with them to understand the precise factors behind this, and to ensure that there is no inadvertent increase in capital requirements for finance to smaller companies.

Ultimately the best guarantee of a stable and reasonably priced supply of credit to SMEs, as to other borrowers, is a stable and competitive banking industry. In the UK, moves have recently been made to improve the competitiveness of SME finance; I believe that the new Basel framework could in turn be a positive contribution to banking stability but we stand ready to monitor developments.

Although this conference is essentially about the issue of banking capital, I would like to end by emphasising that capital is only one component of banking stability; many other factors also come into play. In the field of prudential regulation, I would like to highlight two: valuation and provisioning frameworks, and liquidity management and regulation. There will be little point to all the Committee's work on risk sensitive capital measures if this is not underpinned by adequate loan valuation and provisioning practices - preferably ones which incorporate a forward-looking view of risk and deterioration in loans. A lot of valuable work has been done on loan provisioning by the Basel Committee and other bodies, and I welcome the debate that is currently being sponsored by the IASC on valuation frameworks.

Secondly, adequate liquidity is a vital counterpoint to capital for banks; the regulation of capital adequacy and liquidity are interrelated. Rationally, solvency ought to be a guarantee against funding problems, with customers happy to roll over deposits where they are confident that a bank is soundly capitalised. But reason does not always prevail, in part because solvency is sometimes hard to ascertain, more often because, swept along by animal spirits, markets can behave emotionally and perversely. Capital adequacy and liquidity regulation are thus two sides of the same coin. Just as it would be impossible or uneconomic to require banks to operate without risk to provide total certainty of solvency, so liquidity regulation is needed as a form of insurance. The issue is discussed in an article in the December edition of the Bank's Financial Stability Review. The Basel Supervisors' Committee has done valuable work in examining issues and techniques in liquidity management and this work deserves to be carried forward further. For those of you who have already digested the 500 pages of the new Basel Accord we are discussing today and are looking for some more recreational reading, over the Easter holiday, I thoroughly recommend a re-read of the update the Basel Committee published last year of its sound practices for managing liquidity risk.

In the meantime, thank you for allowing me to address you this morning.