BANK OF ENGLAND

Speech

Prudential regulation, risk management and systematic stability

Remarks by

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Introduction

It is now nearly twenty years since the first Basel Accord on bank capital standards was agreed. During those twenty years the financial scene has changed dramatically: the volume and value of transactions have increased many times; the speed with which transactions are initiated and completed has accelerated; new markets have opened up, not least in the country hosting this conference; there has been an enormous expansion in the range of financial instruments available; financial firms have grown bigger and bigger, and international business has become increasingly concentrated in the hands of a relatively small number of "mega" firms with balance sheets approaching, and in some cases exceeding, a trillion dollars.

The influences driving these developments are well known. First, the world economy has itself grown substantially over the same period, by a factor of something like three and a half in money terms – and financial activity typically increases faster than GDP. Second, there has been significant liberalisation in financial markets and in the environment for international capital flows. Third, technology has advanced enormously in terms of both the capacity of hardware and the sophistication of software.

One great benefit from all this activity has been a dramatic widening of the choices available to savers and investors, borrowers and lenders, and greater flexibility and efficiency in the allocation of capital. But it has at the same time made the world more complicated, with ever-closer interconnections within and between individual firms and markets. This in turn poses some serious challenges for firms themselves, in running their businesses and identifying and managing the risks they face, and for the financial authorities, who are responsible for maintaining the overall stability of the system and trying to ensure that financial markets and financial firms operate prudently and fairly.

Financial stability

Many factors contribute to the stability or otherwise of the financial system. Perhaps the most important is stability in the macro-economic environment. History shows

that episodes of financial instability have often originated in poorly-judged macro-economic policies or failure to respond appropriately to external macro-economic shocks. But financial stability also depends on having a robust structural framework within which to carry out financial business. That means, for example, a reliable legal environment which ensures that contracts are clear and enforceable, an effective regulatory regime which is not unnecessarily burdensome but ensures that the public interest in the behaviour of financial firms is properly taken into account, an infrastructure which ensures that transactions once entered into are completed in a reliable and timely way, and an approach to disclosure which provides accurate information promptly to all interested parties.

This is a very broad territory and in my brief comments this morning I am going to focus on just one part of it – prudential regulation and risk management – and on three particular questions. These questions have one thing in common - they are all concerned with the way behaviour at the level of the individual firm can influence the behaviour of the financial system as a whole. The questions are:

- how far is the new Basel II regime likely to reinforce cyclical changes in credit conditions?
- how significant is the shift in banking practice, from "initiate-and-hold" to "initiate-and-distribute", in terms of the overall management of credit risk?
- what about liquidity?

Procyclicality

Almost any kind of regulatory capital regime has the potential to generate or reinforce cyclical effects in bank lending. As economic conditions deteriorate, the level of provisions and write-offs is likely to rise with a corresponding reduction in banks' capital base. If lending is capital-constrained, this may lead to a tightening of lending conditions. And conversely, when the economy is strong, loan losses decrease and banks' capital tends to rise, allowing a faster expansion of lending.

There are, however, a lot of "ifs" in this argument, including most obviously the question of whether banks do in fact run their business with capital at or just above the regulatory minimum. In practice, certainly in countries where the banking sector

is subject to strong market discipline, they do not. For the most part, they aim to maintain levels of capital significantly above, and in some cases very significantly above, what the letter of the regulatory rules requires.

Basel II, however, introduces a further effect which at least in principle might act to increase cyclical swings in behaviour. Under Basel I, risk weights were assigned on an essentially static basis depending mainly on a sectoral classification of individual loans. Under Basel II, in contrast, not only does the capital of a bank tend to fluctuate with the economic cycle – higher in good times, lower in bad – but the measure of risk-weighted assets also fluctuates, typically declining when the economy is strong and increasing when it is weak. These two effects reinforce each other and, taken together, clearly have the potential to generate more pronounced cyclical swings in credit conditions.

This feature of Basel II was recognised during negotiations on the new Accord, but the extent of its potential impact was perhaps not fully taken on board until relatively late on. This is not the occasion to get into the details of "through-the-cycle" versus "point-in-time" loan ratings, although initially at least the designers of Basel II were probably thinking more in terms of the former, "through-the-cycle", approach. Faced, however, with the banks' own practice, which varies but is often focussed on relatively short-term projections of credit risk, the approach to loan ratings which has in the end been followed is closer to the "point-in-time" version, with the corresponding potential for larger cyclical fluctuations.

The key question, however, is whether all this analysis of what might happen in theory is likely to hold good in practice. Many studies have been carried out aimed at providing an answer without, I think it is fair to say, arriving at any definitive conclusion. Some of these studies suggest that regulatory capital requirements could fluctuate overall by as much as 40% between peaks and troughs of the cycle, and by considerably more than that for some components of banks' loan portfolios. At the same time, the relatively benign and stable economic conditions which have been sustained in many economies over the past decade or more have led to figures for regulatory capital under Basel II which are sometimes significantly below those

indicated by the existing Basel I regime. The numbers in the new Accord remain however to be reviewed, at least at the level of detail, in the light of experience.

But regulatory requirements are not necessarily the factor bearing most directly on the capital which banks, especially major international banks, seek to maintain. Participation in certain markets – for example swaps and repo – in practice requires capital to be well above the regulatory minimum and is heavily dependent on a bank's credit rating. The impact of Basel II will therefore depend importantly on how market counterparties, rating agencies, investment analysts and commentators interpret the new numbers. How far will they distinguish between structural and cyclical factors? How much of a buffer "on average" might banks be expected to hold? These uncertainties are increased further by the recent introduction of new international accounting standards which can have a material effect on traditional financial measures.

In some countries, though, market discipline is not very strong and this puts more weight on supervisory oversight. Basel II makes provision for the exercise of supervisory discretion through its so-called "Pillar II", which allows supervisors to encourage or require banks to build up buffers of capital in good times against the prospect that capital requirements may rise substantially if or when economic conditions deteriorate. This of course implies that buffers should be just that – in other words that they should not be regarded as a permanent part of the capital requirement but should be allowed to move up and down as conditions change. To put this into practice, however, means taking a view on the cyclical environment which firms face, not just in their home territory but, for international firms, across the whole of their business. This is a judgment which, for a variety of reasons of both principle and practice, financial and specifically supervisory authorities may find it difficult to make.

On the basis that regulatory capital requirements <u>can</u> have some cyclical impact, there remains an important question about what, if any, policy response is indicated. The fact that the effect arises from regulatory rules does not in itself imply that the appropriate response is through some modification of those rules. Many factors contribute to cyclicality in the economy and a variety of instruments, including

monetary policy, may be available to address them. But the effect of monetary policy may be constrained because, for example:

- while tighter monetary policy may rein back lending, looser monetary policy may not be so effective in stimulating lending. This is essentially because monetary policy has a more direct effect on liquidity conditions than on capital. There was some evidence of this asymmetry in the United States in the early 1990s and more recently in Japan.
- use of monetary policy to try to stabilise credit conditions may not sit easily with some monetary policy frameworks, including the use of inflation targeting.

Overall, this suggests that it would be premature to contemplate further policy action now to address cyclicality issues arising from Basel II but that, as experience with the new regime accumulates for firms but also for regulators, it is an issue which needs to be kept under review.

Credit risk transfer and bank intermediation

The importance of Basel II from the point of view of its wider economic implications arises because banks typically remain the principal channel of financial intermediation and the principal source of credit for the economy as a whole. At the same time, recent years have seen extremely rapid growth in instruments and markets which allow the transfer of credit risk both within the banking sector and to investors outside the sector. Although reliable and comprehensive data on credit risk transfer is not available, recent surveys by, for example, the British Bankers Association (BBA) and Fitch Ratings indicate just how rapid that growth has been. From almost nothing in the mid-1990s, the BBA estimate that the credit derivatives market had expanded to about $1 trn by 2000; and that the gross outstanding stock of credit derivatives of various kinds has now reached $20 trn. This compares with a figure for the overall credit exposures of the global banking sector of perhaps $30-35 trn.

At least on the face of it, these developments might prompt the question whether regulatory capital requirements against banks' credit exposures now really matter very much. After all, if banks are selling on a significant part of these exposures, how

important from a wider economic perspective is the capital charge against what is left? I think this would, however, go too far.

- First, the figures I have quoted for credit derivatives are gross, whereas what matters more from the point of view of risk redistribution is the net position. The net figures are certainly much smaller.
- Second, despite stories about "leakage", for example to hedge funds and insurance companies, much of the risk redistribution seems to be within the banking sector. To that extent, while the nature of the banks' assets may change, the character of the underlying exposures may not. This does however highlight the fact that conventional credit exposures on the loan book may increasingly be reappearing as market exposures in the trading book, and highlights the importance of the Basel Trading Book Review, which addresses *inter alia* credit exposures arising from trading activities.
- Third, some of the institutions which have been significant absorbers of credit exposure in the recent past may not be able or prepared to continue in that role if credit conditions change sharply; and furthermore many of these "new" lenders may have neither the appetite nor the capacity to provide credit to some parts of the economy, notably small firms. For that reason too, the position of the banks is likely to remain of central importance.
- Finally, one of the key functions of banks is the assessment of credit risk based on a good knowledge of borrowers. For the largest companies, much of the relevant information may be in the public domain – especially if they are issuers of publicly-traded bonds and have a credit rating – and therefore the comparative advantage of banks in making credit assessments may be limited. But for smaller borrowers this will usually not be the case and the detailed credit assessment capacity of the banks has a real role to play. From the point of view of public policy, the question of whether credit risk transfer could impair the overall capability for credit risk assessment – because the knowledge of borrowers available to the originator of loans may not be available to those who end up holding the credit risk – is one which merits further investigation.

In sum, therefore, and despite developments in credit risk transfer, bank lending and therefore bank regulatory capital standards seem certain to remain an important part

of the picture for the foreseeable future. But monitoring developments in credit risk transfer – both the scale and to whom the credit risk is being transferred – will clearly also deserve close attention.

Liquidity

The third and last of the topics I am going to touch on this morning is liquidity.

The term "liquidity" is ambiguous and the concept is not an easy one to analyse. At the level of markets, it means the capacity to execute transactions without significant shifts in the price; at the level of firms, it means the capacity to acquire cash so as to meet obligations as they fall due. One striking thing about the recent international debate on prudential regulatory standards is that liquidity, in contrast to capital, has received relatively little attention. Certainly – and some may judge this no bad thing! – we are a long way from anything remotely corresponding to a Basel Accord for liquidity.

One of the main problems in analysing liquidity is that liquidity conditions are, to use the jargon, endogenous - that is, the liquidity conditions facing one market participant depend crucially on the behaviour of other market participants. And, to make matters more difficult still, market participants are likely to behave "strategically" – that is, their behaviour will reflect guesses about what other market participants will do. This contrasts with the situation in relation to capital requirements against credit risk which depend much more on developments in exogenous conditions, such as fluctuations in economic activity.

In any event, the question of liquidity regulation was not addressed, except in a very general way, in Basel II. It would clearly be unwise, however, to conclude that liquidity is unimportant, either for the robustness of individual firms or the stability of the financial system as a whole. In the end, banks fail because they run out of cash; and while private money markets may now be much deeper than in the past, so that solvent banks should be able to access liquidity against good collateral, there are nevertheless sufficient uncertainties in this process, especially during times of stress, to make prudent liquidity management a top priority.

But as well as the broad prudential reasons for taking an interest in how banks go about their liquidity management, there are more specific reasons for a public policy interest. The ultimate source of liquidity in most economies is the central bank. Its operating procedures have a crucial impact on the environment for commercial banks' own liquidity management. The central bank is also typically the Lender of Last Resort. The existence of this backstop has the potential to induce moral hazard – meaning that banks may become less careful with their liquidity management, and their financial management generally, than they would be if the backstop were not available. For that reason, some oversight of banks' behaviour in this area seems justified – but there is no broadly accepted model of how this should be carried out. Developing such a model would mean tackling not only the theoretical difficulties I referred to a moment ago but also a number of practical issues – for example, whether to focus on a consolidated group position or individual legal entities, whether to distinguish liquidity positions in different currencies, how to integrate liquidity held as a requirement for payment system membership with overall liquidity requirements, and how to combine limits on maturity mismatches with requirements on stocks of liquid assets.

This set of issues clearly has an important international dimension, especially in relation to so-called Large Complex Financial Institutions, which operate in many different countries. The issues concern not just what the "rules of the game" should be in times of market stability but how liquidity pressures should be handled, and by whom, in times of crisis. The Basel Committee is beginning to engage in a limited discussion on liquidity, starting essentially with a mapping of current national practice. In addition, the European Commission has launched a study of liquidity-related issues as part of its effort to integrate further European financial markets. But these represent only very early steps. The question of whether there would be merit in some international understanding on liquidity management, and if so what form that might take, is still to be resolved.

Concluding remarks

As I emphasised at the beginning of these remarks, risk identification, risk measurement and risk management have become increasing challenges in an ever more complex and interconnected global financial system. The three issues I have picked out are just a few of those which practitioners and the authorities face. All of them seem to me important and on each there is still much to do. I hope my remarks this morning have indicated why we think they are important – and, given the speed with which financial innovation spreads, important not just for the UK or international markets but important also for fast-developing markets in emerging economies.

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