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SPEECH

McDonough: The Changing Role of Bank Capital

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Remarks by President William J. McDonough at the Japan Society Corporate Luncheon Series

Good afternoon. I am pleased to be here today to discuss the role of bank capital. Capital, of course, is a topic of great significance to bankers, shareholders and depositors, not to mention bank supervisors and central bankers whose job it is to oversee the soundness and stability of the international financial system. It also is a particularly timely topic. Indeed, the increasing strains under which banking systems in Latin America, Asia and elsewhere around the world are currently operating have underscored the important role of capital. We have witnessed the dramatic effects of weak banking systems on both developed and developing economies and the repercussions these have had on financial markets everywhere. We are reminded, on each occasion, of the need for strongly capitalized financial institutions.

Also, in the last several years we have seen the increasing diversity and complexity of risks to which banks are exposed, including credit risk in its various forms, market risk and operational risk. My goal today is to focus on these risks and to emphasize that the need for strong bank capital levels is clearer than ever. Further, I will discuss how the changing nature of these risks is challenging both bankers and supervisors alike to rethink how they look at capital and capital regulation.

First, let me begin with a bit of background on the role of bank capital, why banks hold capital and why supervisors are so concerned about the amount of capital in the banking sector.

Fundamentally, the role of capital is to act as a buffer against future, unidentified, even relatively remote losses that a bank may incur. A bank must hold enough capital to cushion both depositors and senior lenders against losses, while leaving the bank able to meet the needs of its customers. Banks must maintain capital commensurate with the amount of risks that they take and hold enough to weather financial storms, which can at times prove to be severe and of considerable duration. Banks with low equity capital and a high variability of operating earnings have proven highly vulnerable to financial distress.

However, banks do not just hold capital to overcome distress, but also because it provides them with financial flexibility. Banks which are strongly capitalized can take advantage of growth opportunities. A strong banking sector with a strong capital base is better able to supply credit to businesses and fund investment opportunities that promise to encourage growth, create employment and contribute to a stronger economy. On the other hand, a weak banking sector, with banks unable to function effectively as risk intermediaries, inevitably leads to inadequate credit and liquidity in financial markets and to banks that are unable to boost the productive capacity of the economy. Clearly, this has a grave social impact. Given the importance of credit and liquidity to the overall economy, it is clear why supervisors have a strong interest in the issues of capital adequacy and capital allocation and thus, focus so much effort on capital regulation.

A strongly capitalized banking sector also is better able to promote innovation, whether in the form of new products, new services or new distribution channels. This is not just a capital resource issue, but a human resource issue. Bank managers who are able to focus on the business of banking, strategy and competition, rather than on financial difficulties, can create and innovate and, therefore, add value to shareholders. Moreover, the issue of shareholder value is increasingly important to bankers who must vie for capital resources with a growing field of competitors. As financial services converge, banks find that they are competing for capital, not only with their domestic and foreign counterparts, but also with investment funds, asset management firms, investment banks and insurance companies. In the face of increasing competitive pressures, banks are spending more of their time focusing on the role of capital, capital levels and targets, and how they relate to strategic plans and objectives.

A strong capital base is not just the concern of bankers, regulators and shareholders. More and more it is a factor considered by key customers, particularly those with long-term financial contracts with their banks. Clearly we know this to be true with depositors on the retail side, but it is equally true on the wholesale side. When an institution or corporation enters into letter of credit guarantees or swap contracts, it needs to be confident that its bank will be around in three or five years, at the maturity of the contract. A bank that is well-capitalized can credibly state to its customers and clients that it can make good on its promise to pay. More and more, clients recognize this and differentiate among various players in the financial markets on this basis.

Let me now turn to one of the themes I want to highlight, which is the multiplicity of risks to which banks are exposed and how some of these risks have become more prominent in recent times, again, underscoring the need for strong capital levels.

Credit risk remains the predominant risk for most banks, namely that a borrower will be unable to repay. Credit risk is particularly problematic for financial institutions, as it tends to vary with the business cycle. Often, we have seen the initial rapid expansion of credit accompanied by falling spreads, followed by a curtailment of credit and a widening of spreads. Usually, banks and other lenders suffer substantial losses in the latter stage. We have seen this cycle played out numerous times-with the high-yield bond and leveraged buyout lending markets in the U.S. at the end of the 1980s, with real estate in the U.S. in the early 1990s and more globally, in Latin American investment and lending in the mid-1990s, and in Asia, Russia and other developing countries in the late 1990s. Credit to hedge funds and other highly leveraged institutions typically falls into this pattern as well.

Today, the credit risks to which banks are exposed have become even more diverse and complex. Banks are taking on credit risk in the form of margin lending or transactions in the over-the-counter derivatives business that expose them to large amounts of counterparty risk. They also may be engaged in taking on credit risk in its more subtle forms. The short-term credit risks in futures brokerage, where the clearing broker stands between the customer and the exchange, or the often underestimated, but substantial, credit risks that arise in settling foreign exchange contracts, are examples. Credit risk also may exist in more complicated, less conventional forms, such as credit derivatives and asset securitization transactions.

Regardless of the nature or form of credit risks, the best way for banks to protect themselves is to identify credit risk correctly, accurately price it and maintain high levels of reserves and capital-and to maintain these standards in both good times and bad.

Capital also protects banks against market risks. The upheavals in both global fixed income and equities markets over the last year led to a great deal of volatility in spreads and asset prices and caused large swings in bank profitability. It is just these kinds of market events, often referred to as "tail events", that require banks to maintain strong capital levels. These events inform us that the world doesn't necessarily work the way we thought it did, that there are correlations between markets that we had previously thought of as unrelated. Technological advances and market creativity are contributing to ever-more complex financial products and market risks. Further, the time which it takes banks to alter their risk profile has shortened as larger, sophisticated institutions engage in more trading of securities and derivatives. Thus, assessing the capital adequacy of a bank at any given point has become a far more difficult task than it was as recently as a decade ago.

But banks are exposed to more than just credit risk and market risk. Banks must hold capital as a buffer against business risk, that is, the risk that a bank will lose ground relative to its competitors or competing products, and fail to earn a market rate of return in a business. Capital also covers the potential for declining revenue generation if the bank takes strategic missteps.

Capital also provides a cushion against the enormous costs of fast-paced technological change, especially in the information systems area. For example, consider the looming risk of Year 2000 remediation and the urgency and the rising cost estimates to address it.

Capital also provides a cushion against operational risk, that is, a breakdown in internal controls that can, for instance, lead to fraud or processing errors and result in losses. With the continuing diversification of banking, the fast pace of financial innovation, and the growing concentration of the crucial payments, settlements and custody businesses, the importance of operational risk is rising, especially at many larger institutions.

I have presented the various risks to you as separate and discrete, but more recently we have discovered that market risk, credit risk and operational risk are indeed inter-related. For instance, we have seen that market risk frequently drives credit risk. Clearly, we saw that turbulence in fixed income markets led to credit issues of liquidity and solvency for hedge fund market participants. Also, credit risk may derive from operational risks, buried deep in the details of specific operations which make use of collateral or intra-day funding - both of which require very tight internal control environments.

The framework that I have just outlined for you that relates risk to capital extends equally to financial institutions in emerging market nations. Banks in these nations need to have strengthened capital levels for many of the reasons I have just outlined for you.

But further, we need to be cognizant that international competition now reaches banks in developed and emerging market countries alike, even in what were previously thought to be solely domestic markets. The ever-growing inter-relatedness of national banking systems in a global capital market, and the inclusion of more and more emerging market players as active participants, have challenged banks and supervisors in developed and developing countries alike to strengthen capital levels and to think about a level playing field across all nations.

As ever greater numbers of emerging market banks participate in the international financial system and compete with internationally active banks in their own domestic markets, the importance of strong capital as the underpinning of a safe and sound banking system in these countries becomes more apparent. Emerging market banks recognize that an adequately capitalized institution is a necessary, but not sufficient condition, to compete globally and to attract international funds and clients. It will be particularly challenging for these banks, and particularly those with high-risk profiles and opaque financial statements, to prove to clients and stakeholders that they are operating safely and soundly.

Further, banks in emerging markets typically are subject to a unique set of risks posed by the financing and investment cycles of their countries. For instance, those banks that fund their domestic assets with foreign currencies, whether dollars, euros or yen, may be particularly susceptible to liquidity risk when sharp fluctuations in exchange rates and market turbulence make it difficult to retain sources of financing. This clearly was the case during the recent banking crises that affected a number of Asian countries.

Before turning to what these developments mean for the supervisory capital framework, let me tell you what they mean going forward for banking institutions.

Banking institutions are being challenged to develop better ways of managing and assessing capital that fully incorporate the many inter-related risks they have to take on. Many banks are in fact focusing more attention on assessing their own risk profiles and evaluating the amount of capital they need to cope with adverse outcomes in normal times and under reasonable stress scenarios. The more sophisticated banks are in the process of developing internal systems and methodologies, including formal analytical models, that enable them to better do this. Some of these banks rely in part on analytical techniques that they use in making business and risk management decisions. While many of these systems and methodologies are still in their initial stages and require refinement, I am encouraged by their development, and hope that the assessment of capital adequacy will continue to be a primary focus of risk management at banking institutions.

The senior management of banks can take this further by evaluating not only the adequacy of their current capital levels, but also the appropriateness of their capital structure. Ideally, this analysis would lead to a process that integrates decisions about business strategy, risk profile and future capital needs.

As banks become better at identifying and quantifying their risks, they should be well-positioned to enhance risk disclosures and better inform investors. While bank investors ultimately bear the risks of the institution, too frequently they are not in a good position to make knowledgeable business decisions about a bank's prospects. Certainly, investors are less well-informed compared with bank management. In economics, this is considered an "information asymmetry", but the issue clearly is not just an academic one. Accounting and disclosure standards are problematic in countries that do not assure users of financial statements with the necessary information to appropriately assess risks and determine soundness. A lack of transparency discourages capital from flowing efficiently, and in effect, reduces or even destroys value. Inadequate transparency contributes to further crisis in times of financial distress, as we have seen recently with the Asian banking crisis. However, on a positive note, I am encouraged by steps being taken in numerous countries to promote disclosure and transparency, for instance, with regard to non-performing loans. Initiatives to enhance the relevance, reliability and comparability of information disclosed by the financial sector have been put forth by the Basle Committee on Banking Supervision, the Euro-Currency Standing Committee and the International Accounting Standards Committee, in conjunction with other national and international organizations. The most important initiatives will be those of national governments to apply these transparency frameworks and the voluntary disclosures of financial institutions. Disclosures to enhance market decision-making include, in particular, better information on asset values and risk management strategies and controls.

Let me turn to what the changing risk environment means for supervisors and the current regulatory capital regime.

Today, a major challenge for regulators is to develop capital standards that address more comprehensively the full range of risks to which banking institutions are exposed. These standards must also better differentiate among high risk and low risk exposures and between weak and strong institutions.

The primary tool of capital regulation currently is the minimum capital ratios that were devised in 1988 by the Basle Committee on Banking Supervision, an international forum of bank regulators. They were set forth in an agreement known as the Basle Accord, and were adopted for two primary reasons. First, the minimum ratios were established to address the slide in international capital levels that was occurring over a decade ago. Secondly, they were intended to harmonize different levels and approaches to capital among the G-10 countries. While these ratios were relatively basic, they have proved very effective at improving capital levels over the last decade.

Over the years, risk management approaches have evolved rapidly, while the Basle Accord has evolved relatively slowly. As market risk management techniques developed, we were able to incorporate a state-of-the-art approach, value-at-risk, in a 1996 Market Risk Amendment. As credit risk management techniques have advanced, and as a new discipline of operational risk has emerged, it has become apparent that the long-run relevance and efficacy of the Basle Accord is waning for the most sophisticated institutions.

Supervisors have long known that analyzing simple capital ratios in isolation can mean drawing incorrect conclusions about the relative strengths of institutions. Thus, they have relied on a review of banks' capital plans and on market discipline, in assessing bank capital adequacy. As banking supervisors go forward, we plan to develop a capital framework with these three pillars-capital regulation, capital supervision and market discipline-and we look to strengthen each of them.

Let me start with supervisory review. The cornerstone of supervisory review is the bank's process for assessing its overall capital adequacy in relation to its risk profile and its strategy for capital level and structure. Supervisors believe they should review and evaluate bank internal capital adequacy assessments and strategies, in addition to bank compliance with regulatory capital ratios. The better the bank's own capital adequacy assessment, the better the supervisor will understand the bank's capital strategy. Inevitably, this aspect takes on greater importance. For one reason, supervisors expect banks to operate above minimum regulatory capital ratios included in the Basle Accord-and prudent assessments can help to inform by how much. For another, supervisors seek to intervene early enough to prevent capital from falling below prudent levels-and bank assessments can provide another useful tool in identifying key issues before they become major problems. With these thoughts in mind, supervisors are tackling the challenge of developing a more systematic approach to the review of capital adequacy. The development of this approach will require international bank supervisors to work in close cooperation to ensure consistency across national borders, and to manage resources more effectively.

Supervisors also are discussing ways to enhance market-based discipline. Most agree there is a greater role for private sector monitoring of banks. Of course, there already exists a fair amount of market-based monitoring; however, the collection and use of these kinds of information is usually not systematic or complete. The first goal is to improve information available to the market. With enhanced risk disclosure, supervisors will be better able to rely on the opinion of market investors. These opinions are reflected quickly in the price of bank debt and share prices, and the ease with which banks can access capital. By relying more on these market signals, supervisors will be better able to identify and address waning capital levels at problem institutions.

To the extent banks develop disciplined internal approaches to evaluating capital adequacy and capital plans, and enhance disclosures, supervisors will be able to place greater reliance on all three pillars and reduce regulatory inconsistencies. The common interest is to keep the Basle standards a floor sufficient to ensure financial soundness, but above which banks themselves will choose to operate. To achieve this, we must fashion a set of standards that does not greatly distort incentives.

Supervisors acknowledge that the current regulations and ratios need to be updated to be more meaningful in today's more complex marketplace. Supervisors are always challenged to keep pace with financial innovation and improvements in risk management practices, and this suggests a frequent monitoring and maintenance program for the present and future Accord.

In closing, I would like to summarize the key supervisory objectives that we are mindful of as we look to revise the Accord and enhance the overall capital framework. Our first objective, of course, is to promote the safety and soundness of our financial systems. Our second is to enhance competitive equality, while allowing for differences among banks based on differences in their risk profiles. These were the original goals of the Accord. Our third is to develop standards that are fundamentally applicable to banks of varying levels of complexity and sophistication, including those in emerging market nations.

In developing this framework over the next year, we plan to consult closely with the financial and supervisory community and communicate openly about our progress. By year-end, we hope to have made great strides in furthering our objectives. Clearly, a well thought out framework that holds true to these objectives is in the best interests of banks, their supervisors, investors and customers.