SPEECH

McDonough: Global Financial Reform: A Regulator's Perspective

November 17, 1999

William J. McDonough, President and Chief Executive Officer

Remarks by President William J. McDonough before the Foreign Policy Association

I am delighted to take part this afternoon in the Foreign Policy Association’s conference on Global Capital Markets and a New International Financial Architecture. It is a special pleasure to be here among so many old friends and colleagues.

In my remarks today, I will focus primarily on issues related to my responsibilities as Chairman of the Basel Committee on Banking Supervision. First, I’d like to give you a brief update on the Committee’s efforts to implement globally an agreement reached initially in September 1997 on Core Principles for Effective Banking Supervision. Second, I’ll describe the Committee’s work to promote improvements in risk management, including some related lessons drawn from the LTCM episode. Third, I will discuss the Committee’s proposal for a new capital adequacy framework to replace the 1988 Capital Accord and give you some idea of what our timetable is going forward. Many of these efforts were initiated prior to the Russian financial collapse in the summer of 1998. There is no doubt, however, that all went into significantly higher gear thereafter.

Let me turn first to updating you on the status of the Core Principles for Effective Banking Supervision. This is an initiative the Basel Committee embarked on in the mid-1990s in the belief that there was a need to foster more effective banking supervision throughout the global financial markets. In developing the Core Principles, the Committee sought to craft a document that would have the legitimacy, quality, and flexibility to meet the needs of bank supervisors around the world. To this end, the Committee made it a key point to consult broadly with other supervisors throughout the various stages of the project, particularly those from emerging market countries.

The Core Principles document that resulted from this process brings together concisely in one place all of the fundamental elements needed to carry out effective banking supervision--a remarkable achievement in its own right. Equally important, in my view, the document also balances the desire to set high standards for supervisory practices with a pragmatic recognition that not all countries are in the same stage of financial market development. As such, the Core Principles document is of particular importance for emerging market countries because it establishes a clear set of standards against which each country’s current approaches and progress can be measured.

I am convinced that the flexibility embodied in the Core Principles--combined with the valuable substantive guidance the principles provide--is the right model for achieving sustainable improvements in financial market practices. The fact that a number of other international groups have in recent years also developed "core principles" in their respective areas of expertise confirms to me the value of the Basel Committee’s approach.

Today, approximately 120 countries endorse the Core Principles. Just last month, I am pleased to report, the Basel Committee, in cooperation with the IMF and the World Bank, produced a follow-up report called the Core Principles Methodology. This follow-up report was initiated in response to requests from a number of countries for additional guidance on how to interpret and implement the Core Principles. What the methodology report does is to develop specific criteria to evaluate how the Core Principles are being implemented in individual countries. The new methodology provides two sets of criteria for each Core Principle. One set of criteria focuses on issues deemed essential for the minimum implementation of the Core Principles; the other focuses on those issues deemed to represent "best practice."

The IMF and the World Bank currently use this new methodology to assess the banking sectors in individual countries. Looking ahead, the Basel Committee plans to bring together sometime next year supervisors from emerging market countries and representatives from the IMF and World Bank to discuss the lessons learned from this initiative. The projected meeting is part of the Basel Committee’s ongoing commitment to ensure that the Core Principles remain on point and relevant to banking supervisors worldwide.

I must stress, however, that the most important efforts to implement the Core Principles continues to be the job of the individual countries. Without the support and backing of national authorities to follow through with the implementation of these principles, our broader efforts simply cannot be effective.

In this connection, the Basel Committee has long recognized the need for effective training and seminars for participants in the global bank supervision community. Over the years it has sponsored numerous programs which have been beneficial in allowing supervisors from different countries to share experiences and exchange ideas for improved practices. Building on its longstanding commitment to these outreach efforts, the Basel Committee, together with the Bank for International Settlements, jointly established the Financial Stability Institute in 1998. The Institute currently conducts leadership training targeted to supervisors in emerging market countries, facilitates technical assistance in individual countries, and provides training on a regional basis.

The Basel Committee also plays a key role in the Financial Stability Forum that was established by the G-7 Finance Ministers and Governors in early 1999. Through the Forum, the Basel Committee is able to share its experience in implementing the Core Principles with other organizations that have embarked on similar initiatives, such as IOSCO, the International Organization of Securities Commissions. More broadly, the Financial Stability Forum is coordinating an effort to improve awareness of and accessibility to training for regulators and supervisors worldwide.

Turning to the Basel Committee’s efforts to promote improvements in risk management, let me comment first on the work related to highly leveraged institutions. As I have discussed in other settings, the LTCM episode and the proper supervisory response to it are fundamentally about two things: leverage and good judgment. Leverage is an important part of our financial system and most of the time it plays a positive role in enhancing market liquidity and ensuring a more efficient allocation of resources. At times, however, financial institutions can go too far in extending credit. This is where the critical role of good judgment comes in. Let's not forget that a banker's two most important decisions are whom to do business with and how far that business relationship should be pursued.

One of the fundamental aims of supervisors is to ensure that banks are using the right tools to make these difficult decisions. These tools include risk measurement methods and risk management techniques that are appropriate to the nature of the risks involved.

Following the LTCM episode, the Basel Committee put together a working group to focus on the relationship between banks and highly leveraged institutions. Our goal was to provide a framework for identifying the broader issues raised by LTCM, the policy responses for supervisors, and the key risk management challenges for the industry going forward.

Under the leadership of Jan Brockmeijer of the Netherlands Bank, the Basel Committee's report was completed in January, 1999. It revealed a number of deficiencies in banks' risk management practices. In particular, we observed an imbalance among the key elements of the credit risk management process, with too strong an emphasis on the role of collateral to protect against credit loss. This undue emphasis caused many banks to neglect other critical elements of effective risk management, including in-depth credit analyses of counterparties, effective exposure measurement, and the use of stress testing.

To make sound credit decisions, banks need to obtain sufficient information about the borrower to provide a comprehensive and timely picture of its risk profile and credit quality. This is true regardless of whether the extension of credit occurs via a loan or through a counterparty trading relationship. Yet the Basel Committee's report found that banks did not obtain sufficient financial information to assess the types and extent of risk assumed by large, highly leveraged institutions. In particular, banks did not obtain the information needed to assess leverage, risk concentrations in particular markets, or the liquidity risk profile of individual institutions.

The Basel Committee report also concluded that banks should develop more effective measures of potential future exposure, which refers to the possibility that credit exposures can change over time as market conditions fluctuate. The ability to measure potential future exposure is critical when dealing with large trading counterparties such as highly leveraged institutions, especially in volatile market conditions. Unfortunately, methods for measuring potential future exposure have not kept pace with the growth and composition of trading activity.

The Basel Committee's report also showed that banks must develop approaches that better account for credit risk under distressed market conditions. A key lesson of the LTCM episode is that credit and market risk cannot be seen as completely distinct, but are liable to interact and reinforce each other under highly stressful conditions. The use of more rigorous stress testing, therefore, could have given banks better warning of the types of exposures they faced.

Together with this January 1999 report, the Basel Committee issued a sound practices document setting forth guidance for banks and supervisors on these topics. For example, these sound practices called upon banks to:

- Establish clear policies governing their involvement with highly leveraged institutions,
- Adopt credit standards addressing the specific risks associated with these institutions,
- Establish meaningful measures of potential future exposure as well as credit limits incorporating the results of stress testing, and
- Monitor exposure on a frequent basis.

I am pleased to report that the Basel Committee's recommendations on highly leveraged institutions have been reinforced by the recommendations of subsequent efforts, including reports by the President's Working Group on Financial Markets and the Counterparty Risk Management Policy Group. There is clearly widespread agreement among both the private sector and the official community about the steps that firms need to take to address the weaknesses in risk management identified in the LTCM episode. The key remaining issue is the strength of the private sector's resolve to implement these measures.

For its part, the supervisory community is carefully monitoring the efforts of banks to follow through with the implementation of improved risk management practices for highly leveraged institutions. The Basel Committee intends to prepare a follow-up report on the progress banks are making. In my view, the degree of improvement will signal whether the industry has truly absorbed the lessons of the LTCM episode.

The approach the Basel Committee has taken with respect to highly leveraged institutions mirrors its efforts in addressing other risk management issues. A primary aim of the Committee is to describe and promote prudent risk assessment and control practices by banks. By setting out the current state of the art in key areas, the Committee provides banks and their supervisors worldwide with the tools to measure industry progress toward the goal of effective risk management.

In recent years, the Basel Committee has engaged in a sustained effort to develop and publicize sound practices in a variety of areas. These have included papers on such topics as:

- the management of credit risk,
- loan accounting and credit risk disclosure,
- guidance for managing foreign exchange settlement risk,
- enhancing corporate governance in banking organizations,
- a framework for internal control systems in banking organizations,

- operational risk management, and
- risk management for electronic banking and electronic money activities.

For anyone interested, the details of these reports are available on the website of the BIS.

Before turning to capital adequacy issues, I would like to highlight some key elements from two recent papers on sound practice. In July, the Basel Committee issued for comment a report on the management of credit risk. This is a particularly important topic since the major cause of serious banking problems continues to be directly related to poor practices regarding credit risk management. A key focus of the report is on the need for banking organizations to develop an overall business strategy for credit risk that incorporates the tolerance for risk and the level of profitability the bank expects to achieve from incurring various credit risks. A strategic approach to credit risk provides a coherent framework for practices in such areas as credit-granting criteria, credit limits, and credit risk monitoring.

The Basel Committee issued a second paper in September that addresses the subject of corporate governance in banking organizations. As you know, corporate governance, especially the role of boards of directors, is of particular interest in this country. More intense competition, rapid change, and increased complexity in many business activities mean that responsible and independent oversight by boards of directors plays a more crucial role in ensuring that the firm's business strategy is sound and its leadership effective.

I am convinced that the need for strong corporate governance is equally great in emerging market countries, where banks and other financial institutions face comparable pressures. The Basel Committee's September paper outlines several elements that are critical to a sound corporate governance process. These elements include the installation of qualified boards of directors with clearly defined responsibilities, the importance of oversight by directors and senior management, the need for clear lines of management responsibility and accountability, and the effective use of internal and external auditors.

Both the July and September reports provide a flavor of the Basel Committee's efforts to promote stronger risk management practices within the global banking community. Although these efforts sometimes receive less public attention than our work on capital adequacy, I believe that they play significant roles in helping to set standards for prudent risk-taking that can be used by banks and their supervisors worldwide.

Lastly, I would like to update you on the Basel Committee's major effort to revise the 1988 Capital Accord. In June, the Committee released a Consultative Paper laying out our vision for a new capital adequacy framework. Our proposed timetable is to seek comments from both supervisors and industry participants through March 31, 2000 and then to publish, hopefully by late next year, a comprehensive set of proposals which are responsive to the comments and industry input we have received.

During the comment period, the Committee and its subgroups are working hard to refine and further develop a number of the proposals put forth in the consultative document. The Committee also continues to consult actively with banking industry representative and organizations through holding seminars, inviting presentations at working meetings, and conducting surveys on various topics.

The Consultative Paper represents an evolution in the Basel Committee's approach to capital adequacy. In addition to establishing minimum capital requirements, the paper places an increased emphasis on the supervisory review of capital adequacy and the role of market discipline. We refer to these elements as the "three pillars" of our proposed capital adequacy framework, which together promote safety and soundness. This evolution in the Committee's thinking about capital follows from much of our recent work on risk management and the surveys we have conducted on banks' disclosure practices.

In our view, the three pillars to assess capital adequacy are mutually reinforcing, each addressing the challenge of aligning capital relative to risk in banking organizations somewhat differently. The Committee's belief is that by combining the approaches of the three pillars, we can better achieve our overall objective of ensuring an adequate capital cushion across the banking system that at the same time recognizes and encourages prudent risk management.

Let me highlight briefly each of the three pillars and provide some perspective on the key challenges that the Committee faces in relation to each. The first pillar has to do with minimum capital requirements. The 1988 Capital Accord allowed supervisors in the G-10 countries for the first time to use a common yardstick for measuring the capital adequacy of banks. While the 1988 Accord was a milestone achievement, its simple risk-weighting scheme has had difficulty incorporating innovations in the way banks today manage and mitigate credit risks.

More fundamentally, the 1988 Accord does not adequately differentiate among degrees of credit risk. As a result, banks have had incentives to take on higher risk exposures within each of the Accord's broad risk categories. Banks have also tended to engage in transactions that lower capital requirements without reducing economic risk. The effect of these developments has been to erode the significance of the Basel ratios as an indicator of a financial institution's capital adequacy, particularly for the large, internationally active institutions which were the original targets of the Accord.

To address these shortcomings in the 1988 Accord, the Basel Committee proposes two primary approaches: 1) a standardized approach that ties risk weightings to external credit assessments such as credit ratings, and 2) an internal ratings-based approach that would begin by mapping internal risk ratings into standardized risk weightings but might eventually evolve into something closer to the full use of credit risk models. Each approach treats the trade-off between simplicity versus accuracy somewhat differently and thus one or the other is likely to be relevant to banks with different levels of sophistication.

Importantly, both proposed approaches attempt to introduce greater risk sensitivity into the minimum capital standards. In my view, it is essential that we move forward in this fashion in order to enhance the responsiveness of required capital to risk and to address the unfortunate incentive problems that have evolved from the 1988 Accord.

Because of the Committee's desire to produce a capital adequacy framework with a greater sensitivity to risk, some observers may note that we inevitably introduce a dynamic element into our standards. That is, the capital requirements for loans to troubled borrowers will tend to increase at just the point when such trouble is becoming apparent. I see an important positive aspect to such an outcome.

I would argue that the global financial system needs to become better prepared to address potential credit problems pre-emptively, before these problems have time to grow from minor disturbances into major disruptions. Implementing capital standards that are more responsive to the dynamics of risk could help move us in this direction and away from a mindset that waits too long to address problems. In particular, the Committee is interested in hearing views on how we should think about these issues.

The second pillar in the proposed new capital adequacy framework has to do with the supervisory review of capital, a critical complement to minimum capital requirements. The Consultative Paper calls on supervisors to ensure that each bank has sound internal processes in place to assess the adequacy of its capital based on a thorough evaluation of its risks and capital structure, thus moving the Accord beyond a ratio-driven minimum capital standard to a comprehensive approach for assessing capital adequacy. In general, supervisors have expected and continue to expect banks to hold more than the regulatory minimum amount of capital. In proposing this supervisory review of capital, the Basel Committee intends to foster a more active dialogue between banks and their supervisors with respect to the actual level of capital banks choose to hold.

I want to stress, however, that this proposed approach to assessing capital adequacy in no way intends to replace the judgment and expertise of bank management. Nor is this approach meant to shift ultimate responsibility for the adequacy of bank capital to the supervisors. On the contrary, I believe that managers are the ones with the most complete understanding of the risks that their institutions face and it is they who must have the primary responsibility for overseeing these risks.

The task for supervisors in this framework is to evaluate how well banks are assessing their own capital needs relative to their risks, including whether banks are appropriately addressing the relationship between different types of risks. To this end, the Basel Committee is currently developing guidance to help supervisors evaluate internal capital assessments conducted by banks. In the event that a bank's internal capital adequacy process is lacking, supervisors must have the knowledge and authority to take corrective action.

There can be no doubt that implementing the supervisory review of capital will require considerable insight and flexibility on the part of supervisors because they will have to tailor their efforts to the unique risk profiles of particular institutions. At the same time, this approach should allow supervisors to draw on their cross-institutional knowledge as they assess the strengths and weaknesses of a bank's risk management and capital allocation processes relative to those of its peers.

The G-10 supervisors recognize the obvious implications that this approach will have for supervisory resources. In order to keep pace with industry innovation, it is clear that we will have to step up our training and consider effective ways for making the most use of our limited resources. The Basel Committee also recognizes the importance of these issues for the non-G-10 countries and is working toward providing the training and other types of support needed to allow these countries and their supervisors to move in this direction.

The third element in the proposed new capital adequacy framework has to with market discipline--another critical component of a safer and more stable financial system. More extensive disclosure and greater dependence on market forces complement improvements in risk management, banking supervision, and minimum capital standards. Of course, to add value over and above the minimum capital standards, improved disclosure must go beyond the simple reporting of minimum capital ratios.

When banks disclose timely and accurate information about their capital structure and risk exposures, market participants can better evaluate risks and act accordingly. The disclosure of timely and accurate information, in turn, is an incentive for banks to ensure that the market perceives them not only as effectively managing their risks, but also as being adequately capitalized. Market reactions to the public disclosures of banks also can play an important signaling role for supervisors in assessing the adequacy of a bank's capital.

A further reason to encourage disclosure beyond the reporting of regulatory capital ratios is that these ratios have become the primary focal point for investors and industry analysts. The result has been that bank managements have had an incentive to focus solely on improvements in these ratios, even when the ratios are not fully reflective of risks. More comprehensive disclosure could lessen this incentive.

With these considerations in mind, the Basel Committee is seeking to design an expanded set of disclosure guidelines, taking into account the proprietary information needs of banks. I believe that fuller disclosure for all banks can take us a long way towards effective market discipline. We also encourage banks to include in their fuller disclosures information specific to their risk profile.

The timeliness and the quality of disclosure are important. The frequency of disclosure should reflect the nature of the risks involved. Moreover, as transactions that shift risk become more common and complex, disclosing the associated residual exposures takes on added importance. Such reporting, in turn, requires that banks have in place the appropriate systems to identify and measure these risks so that the risks can be documented for the marketplace. Finally, as we move toward improved disclosure, we must keep in mind that the goal is useful and reliable information--not simply a large volume of information. More is not necessarily better.

In the area of disclosure, I should also mention that my colleague, Peter Fisher, is chairing a Multidisciplinary Working Group on Enhanced Disclosure, comprised of representatives from the banking, securities, and insurance industries in a pilot effort to formulate a set of public disclosure guidelines that make sense for an increasingly integrated financial market. The working group will assess the extent to which the pilot data can provide a meaningful basis for comparing risk management practices as well as the level and types of risk across institutions and across countries.

The Basel Committee supports this pilot approach. It limits the burden on the banking industry and at the same time makes clear that the private sector has a key role to play in improving disclosure and enhancing market discipline. Firms participating in this program will have the opportunity to shape the exercise and influence the interpretation of its results. Through their participation, these firms will be sending a clear signal about their willingness to improve market discipline.

These have not been easy times for banks. As a regulator, I cannot help but underscore the essential role banks play in the global marketplace. By intermediating credit between savers and investors and providing liquidity to the financial sector, banks are the essential link in well-functioning economies.

Thus, while capital levels and risk management policies are without question important, they do not take precedence over the responsibilities of bankers to serve their purpose in a Schumpeterian world of creative destruction. This most fundamental of responsibilities involves the use of credit judgment. By this I mean that bankers must not lend to excess when times seem good and then lend too little when times appear more difficult. This is an ongoing obligation of banks and is no less so as we approach the century date change.

With roughly six weeks to go before year-end, I believe it critical that banks approach the new year with these thoughts in mind and I call on them to be attentive to providing for their customers reasonable needs. By reasonable needs, I have in mind that banks should think twice about huge demands based on what seems to be customers' excessive concern about Y2K, but grant appropriate credit for realistic needs, even if this involves somewhat greater use of their own balance sheets than would usually be the case.

To aid in the year-end transition period, the Federal Reserve System and the Federal Reserve Bank of New York have announced a variety of steps to assure adequate liquidity in wholesale markets and promote financial market stability. We approved last month an expanded range of acceptable collateral for discount window and payments system risk purposes. In addition, there are in place a number of measures to ensure that an ample supply of cash will be available to meet possible increases in the demand for cash over the transition period. Further, the Federal Reserve created a century date change Special Liquidity Facility for lending to depository institutions from October 1, 1999 through April 7, 2000. Among other things, this facility should help institutions to commit more confidently to supplying loans to other financial institutions and businesses through the rollover period.

Finally, the Federal Reserve Bank of New York announced a number of measures in early September intended by the Federal Open Market Committee to promote the smooth functioning of money and financing markets and to gain greater assurance that we will be able to manage banking system reserves during the century date change. The measures include the expansion of collateral accepted in repurchase transactions, the extension of the maximum term of the Bank's repurchase transactions to 90 days, and the introduction of a Standby Financing Facility.

The next several weeks will be a challenging period, for private and public sector participants alike. By working together in the short-term to ensure a smooth transition and over the longer term to improve risk management practices for banks and develop a meaningful international capital adequacy framework, I am confident that we can be successful in not only preserving, but also enhancing, our global financial system as we enter the next century.

Thank you.