The Future of Regulatory Capital
The Practical Banker’s Perspective

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Ladies and Gentlemen, it is a privilege for me to share with you some thoughts from a practical banker’s perspective on the future of Regulatory Capital, even more so, as somebody working in an international financial conglomerate.

I have read the two papers from ESTRELLA and SHEPHEARD-WALWYN with great interest as they both raise issues that will become more and more critical in the future. Let me try to summarize the most important findings I took out of their papers. Both papers show clearly that formulas don’t work and identify a need to apply a broader view to the problem of defining the capital base necessary for a bank. Additionally both authors stress the fact that capital adequacy is just one tool in the regulators’ toolbox; others, for example, would be standards for Internal Control Systems or liquidity rules, just to name two.

IDENTIFIED DEFICIENCIES

Based on their analysis one can identify three deficiencies of the current regime; these are mostly in the credit risk area. With the implementation of the model approach for market risks, however, these deficiencies have been resolved to some extent. The trend towards a more individualised supervision related to market risks has also given some relief as well. A few points about the deficiencies:

- First of all, the existing rules, especially in the credit risk area, are far too static. This leads to a lack of flexibility to cover new trends in the market place and influences the behaviour of market participants in the wrong way. By securitizing highly graded loans to minimize what we think are excessive capital charges, the average quality of the loan book tends to decrease. This is just one example how regulatory rules lead to unwanted behaviour.

- Second, the capital adequacy rules usually do not consider a financial organization’s existing internal knowledge of its risk portfolio, neither explicitly nor implicitly. Here, the two approaches presented in the papers may remedy the situation. The so-called «regulatory approach» does this explicitly, and the «base-plus approach» does it implicitly, in the same way as in the pre-commitment approach.

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Finally, and probably most importantly, regulators have traditionally taken what I call the «line item view». Let me explain this with three examples: a) capital requirements for loans don’t consider the portfolio effect; one usually looks at loans to a counterparty as if they were individual transactions, b) capital requirements for an entity don’t consider the level of diversity within that entity, and, finally, c) capital requirements for a conglomerate don’t consider diversity across different entities in a financial conglomerate.

All this leads to capital charges one could perhaps consider excessive and to a sub-optimal allocation of resources within the economy overall.

POTENTIAL TRAPS

Before moving on to critical areas for the future, let me quickly mention two potential traps that were stated in the papers:

- First of all, I think that the «level playing field» argument is an illusion. As we all have seen through the developments of the last twelve months, size plays a crucial role. Not only because of critical mass, but even more so because of diversified income streams. Larger or merged entities typically don’t take proportionally larger risks to one and the same counterparty. This fact leads to stronger entities and an increased ability in general to sustain large losses. So, while the goal of a «level playing field» is an admirable one, it only really works for similar entities, similar with respect to size but also with respect to business activities and geographic scope, e.g. for entities competing globally.

- Second, we have to watch out that we don’t try to measure all and everything. As management of operational risks within firms show, banks have successfully managed operational risks historically, even without statistically modelling or quantifying potential loss figures for operational risks, just to name one example. Consequently, regulators should use other tools in their toolbox to control these risks, for example the setting of Internal Control Standards or similar. Moreover, regulators should state explicitly which risks are to be covered by capital and which aren’t.

FOCUS AREAS FOR THE FUTURE

So, moving forward from here, I think regulators, jointly with industry participants, should focus on the following fundamental adjustments to the current system.

First, we should clearly define which losses are to be covered by capital. In order to do this, I think the classification used by Shepheard-Walwyn is very meaningful in helping to understand the issue:

- All expected losses are to be covered by adequate product costing mechanisms.
This way, it becomes clear, that capital should primarily be used to cover for unexpected losses.

As to stress losses, diversification is the key word here. Capital charges should only be used in a second step, and, because stress losses in a diversified firm are more or less independent, any rules should at least allow for some double counting. One way to do this would be to compare total capital of a firm with historical losses in the industry, appropriately adjusted to the size of the firm we are looking at.

Clearly, the capital adequacy rules should be more transparent to state which types of losses are to be covered by capital and which aren’t.

Second, the risk classification developed by the BIS in 1994 should be refined. While market risks and credit risks are widely accepted the so-called settlement risk doesn’t really fit into the overall risk framework. By its nature, settlement risk is no different to other credit risks, only with a shorter maturity. If we want to move forward to a model approach for credit risk capital calculation, it is important that the risk classification applied is consistent. As the insurance business tends to gain importance, especially for financial conglomerates, we should as well think about creating a new risk class to cover this. In a more general sense, capital requirements should focus on risk types rather than on asset types or types of activity. For example:

- The actual treatment of fixed assets such as real estate in today’s rules is quite contrary to this, and, as already noted earlier, leads to undesirable results. Because of excessive capital charges for real estate, banks will try to offload as much real estate as possible, which is fully understandable in the current risk / return context.

Third and probably the most important adjustment to today’s rules is the explicit consideration of any positive portfolio effects. This portfolio effect should be considered on three levels:

- First, we should move from a single transaction view to a portfolio view, especially for credit risks. The industry’s thoughts on implementing a model approach for credit risks tries to resolve exactly this crucial point and the regulatory framework should be based on this methodology as well.

- Additionally, diversification effects also exist across different risk types, e.g. between market risks and credit risks. Statistically speaking, the present regime assumes full positive correlation between market and credit risks, as the capital available has to be split between those two items without allowing any double counting.

- Finally, the same argument can be made for different businesses or entities within a financial conglomerate.

Let me put one point straight here: I am not proposing that, overall, the banks need less capital than they have today. But it is important to have full transparency as to the risk types to be covered by capital. While the 8% rule for loans may very well ensure that a typical corporate bank on average has sufficient capital, it motivates the wrong behavior, and, as firms develop with the current rule in mind, it won’t capture the risks properly anymore.
BASE-PLUS APPROACH

Let me conclude with some final remarks on the suggested base-plus approach:

- I think it may be a valid alternative to the pre-commitment approach, but, as with the pre-commitment approach, the problem of setting the right penalty structure also exists.

- Additionally, at least for the time being, its focus is on market risk, while we would need to have an approach that is able to cover ALL risk types, or, at least, one that covers market and credit risks jointly.

- Finally, the base-plus approach is founded on the key assumption that the optimal amount of capital in a well-run firm is higher than the regulatory capital amount. In order to be able to use the base-plus approach, we bankers will have to assure regulators that our institutions will continue to behave consistently with that key assumption.

To summarize, the base-plus approach is a step in the right direction, but it isn’t the complete solution for the more fundamental issues raised earlier.