The Practical Banker’s Perspective on Precommitment

ROLF ENDERLI*

Ladies and Gentlemen, I am very glad to have the opportunity to speak to you today about a practical banker’s perspective on the precommitment approach.

Please let me first state my opinion, that we are at a very critical point of banking regulation. This is mainly because banking has become much more complex since the introduction of the Basle Accord in 1988. It can be explained to a major extent by taking into account the following tendencies caused by advances in information technology. These advances allowed risks to be split into their separate parts, traded in separate instruments respectively. Some instruments and their embedded risks therefore now seem more complex. In fact, they are not, however, appear with another face. Banks have responded to this seemingly more complex instruments with sophisticated risk management systems. Regulators on the other hand have continuously responded to this by more detailed regulations. Advances in information technology together with the ongoing globalisation of financial markets, deregulation in various jurisdictions have finally also lead to a significant increase in competition, which is now taking place on a global level.

Keeping these tendencies in mind, I would like to continue by first reviewing some general assumptions of the current regulatory principles. I will then continue by discussing some questions arising with the implementation of the precommitment approach solely for market risks in the trading book. Then I will analyse whether it would also be a useful approach for a universal bank such as UBS. Finally I will turn back to the basic question, whether capital as such can foster the safety of individual institutions and decrease systemic risk for the whole economy.

In looking at the current regulatory regime, we should apply the principle «Sharpen the Saw». We realize that all amendments to the Basle Accord have something in common: they are all going too much into details and one fears to lose sight of the main points. Additionally these detailed amendments impose huge administrative costs to the banks and the regulators, especially in the case when the banks disagree with the regulators. Banks have then to support their internal models as well as the models designed by the regulators. Furthermore, they strongly reduce flexibility of the regulators and of the banks, as the new regulations always lag behind the latest developments. To circumvent these problems, I would in principle favor the following approach: Regulators would follow a top-down-approach. This means they would regulate according to some simple, understandable rules, which would allow to see the whole picture. Banks themselves would internally follow an bottom-up-approach, with models such as VaR, stress scenario analysis, etc.

* UBS AG
In principle, when applied for market risk in the trading book, the precommitment approach is a move into the right direction as regulators use a top-down-approach, whereas banks a bottom-up. I would like to continue my more detailed analysis by reviewing some basic assumptions of this approach when applied for market risks in the trading book. The first is in my opinion, that banks and regulators both have the same vital interest in preventing situations, which could lead to an individual bank failure or even a systemic crisis. The second is, that banks understand the risks they are facing and that regulators do not necessarily know better how to manage them. I fully agree with these first two assumption.

The third assumption of the precommitment approach is, that regulators can influence the amount of precommitted capital through the introduction of penalties and therefore increase the resistance of banks against a systemic crisis. This in turn leads to the forth basis assumption, that capital is the tool to achieve this.

Please let me review the third assumption first as I will turn to the forth at a later stage of this speech.

The question of penalties is probably the most widely discussed issue in connection with the usefulness of the precommitment approach. A review of the academic literature shows that no definitive theoretical solutions have been found. From a practical point of view, however, I can not think of any sanctions which could eliminate the problem, that the precommitment approach leads to stop-loss behavior. This in turn would much more increase systemic risk, than reduce it.

However, applying a precommitment approach only for market risks in the trading book would, in the case of UBS, not have a significant impact in that sense, that if the precommited amount was too small, the losses could be absorbed by a capital basis, which is a multiple of the amount set aside for market risks in the trading book.

The difficulties start if such an approach would be applied for the whole bank. The before mentioned set of assumption had to be amended with two further assumptions. The fifth would be that one could develop a full factor model, which would aggregate all possible risk factors such as market risk, credit risk, operational risks, etc. Such a model would also be based on the fact, that reasonable estimates for the market value of all balance and off-balance sheet items could be obtained. The reason therefore is that it would not make sense to precommit capital on a group basis only for selected risks. A further assumption is, that one would find a solution on the normalisation of time-horizons for different risks.

Looking at theses two additional assumptions I would like to stress, that in my opinion it would be very difficult to agree on a model which can incorporate all relevant risks and to value mark-to-market positions such as mortgages and customer savings accounts. However this issue should be discussed in more detail at other times. The problem associated with the normalisation of time-horizons is twofold. First it would have to be agreed on a time-horizon for the different risks. This is because it would make no sense to take the same precommitment periods e.g. for the market risk in the trading book and for credit risks in the banking book due to the different nature and liquidity of the po-
sitions. However, if a number could be agreed for the different risks, the question would still remain, whether this could be aggregated to a single number for the whole bank.

Besides the critical analysis of the amended set of assumptions for the application of the precommitment approach for the whole bank, I strongly like to question one implication. Sanctions on a corporate level would be useless, as they would always come too late. In the absence of explicit sanctions however the precommitment approach would be difficult to implement.

Summarising the above mentioned thoughts, I think, that a precommitment approach could probably be applied for selected risks — although certain shortcomings — as long as these risks only have a small impact on the overall risk position of the bank. However it should not be applied to the bank as a whole.

Now please let me turn to the assumption which is inherent in the precommitment approach as in all other regulations concerning capital adequacy. It is the thesis that capital can foster the safety of individual institutions as well as that of the industry as a whole.

Let me start my analysis with an ideal world in which a bank will always receive new money as long the capital is positive. The new funds to be received by a bank in a certain period of time would therefore be a function of capital, holding other factors such as the quality and volatility of assets and liabilities constant. Accordingly, if the capital base would get weaker due to losses, a bank could always rise borrowing rates in order to ensure the inflow of new funds until the assets would not cover the liabilities anymore.

In practice, however, capital markets do not work this way. One can observe that at a certain point in time banks can not receive additional funds at any rate although they still have capital well above zero and sometimes even above the regulatory minimum. What is the reason for this market inefficiency? In my view it is a lack of liquidity not capital. Let us look at a potential bank crisis more closely. In the beginning, a bank often had a loss for a certain period. Management then tries to recover from this situation through restructuring plans. At the same time, borrowing rates raise as the market also becomes aware of this situation. However, the bank has still potentially unlimited access to the capital markets as long as a certain higher spread is paid to the investors. If these restructuring plans do not work and the bank continues to make losses, the borrowing rates have to rise again to ensure the desired cash inflow. If the inflow is not sufficient the bank starts to make repo transactions above the normal level. This process can go on until the losses, which are now even higher due to the higher costs, would have offset the capital. However it does not. At a certain point well before that this process stops and a bank is considered illiquid. The only way to get additional funds in then is to liquidate illiquid assets at prices well below their going-public prices. This creates additional losses. Under which circumstance can a bank therefore survive without help by the lender of last resort? In principle, a bank can survive, if the additional loss occurred by the bank through the liquidation of illiquid assets and the higher funding spreads during the period of crisis do not eat up all the capital or falls below a certain regulatory limit as defined in most commercial codes. This would imply that a bank must hold enough capital in order to survive a liquidity crisis. This amount is however not easy to be defined.
What conclusions can been drawn from the above stated arguments. First, information technology surely leads to important changes in the banking sector, including segregation of risks, sophisticated risk management systems, new regulatory standards and increased competition. Second, in defining standards, regulators should use a top-down approach, banks a bottom-up. Third, the precommitment approach could probably be applied for selected risks – although certain shortcomings – as long as these risks only have a small impact on the overall risk position of the bank. However it should not be applied to the bank as a whole. This leads to the forth conclusion, that in order to ensure the safety of the whole institution one should start with looking at liquidity not capital. Liquidity analysis should in turn come away from its static view.