The Supervisor's Perspective on Precommitment

DANIEL ZUBERBÜHLER*

1. THE FUTURE OF CAPITAL REGULATION

Before entering into a discussion of the merits and deficiencies of the Precommitment Approach (PCA) from a regulatory perspective, we have to look at the overall perspective for the future of capital adequacy regulation. It is no longer a secret, that the Basle Committee on Banking Supervision has embarked on a broad discussion of the future framework, responding to the financial sector's criticism of the crude standardized approach for credit risk in the 1988 Basle Capital Accord. Whether this discussion will lead to a major overhaul of the entire system or merely to minor amendments to eliminate some obvious inconsistencies, is competely open at this early stage. As TIM SHEPHEARD WALWYN rightly put it, «we are now at a point of greater uncertainty about the way forward than we have ever been». Thus I can only give my very personal view on some guiding principles for the way forward, summarising a paper which I submitted to the Basle Committee in March 1998:

1. Large, complex global financial institutions (banks and securities firms; «core institutions» in the terminology of the G-30 Report1) present a higher systemic risk. Thus they need particular supervisory attention to protect the national and international financial system and ultimately the taxpayers against the consequences of their failure. In the 1988 Accord we have unfortunately even increased systemic risks by giving a preferential, extremely low risk-weighting to (inter-bank) claims against OECD-banks2, which has recently been extended to securities firms.

2. In order to minimise systemic risks, core institutions need to meet higher regulatory standards in every respect. The G-30 Report acknowledges this with regard to risk management, disclosure and enhanced supervisory techniques, but not for capital adequacy, where it pleads for discounts in favour of well-managed institutions. However, improved internal control mechanisms – or a more intensive and sophisticated

* Director, Secretariat of the Swiss Federal Banking Commission, Berne.

2. In the Swiss Banking Ordinance (Art. 12a, Section 1, Para.2.4, 3.2, 4.2), we have been more prudent, by assigning higher risk-weights to inter-bank claims based on the residual maturity of the claim: 25% up to 1 year; 50% between 1 and 3 years; 75% over 3 years. In addition, claims against OECD-banks with a rating below investment grade, are excluded from the preferential risk-weighting.

supervision – cannot be regarded as a substitute for equity capital. Instead there are good reasons to ask for effective risk management and high capital standards for the crucial pillars of the financial system. Consequently, we should impose higher capital standards for core institutions as a vital cushion against break-downs of risk management and control-systems, which – as we all know – can always occur in spite of the constant progress in risk management techniques. Let me restate, that we do not intend to impose significantly higher capital standards in isolation on a national level for Swiss global banks only. For competitive reasons, such a move must be coordinated internationally, and there is no guarantee that the Swiss view will be shared by a majority of the Basle Committee.

3. For core institutions the minimal standard of the present Capital Accord is just not enough, because it only encompasses credit risk and market risk. If capital requirements are to be risk-adequate, then they should cover all significant risk categories. Since we are dealing with the top-brass of sophisticated global firms, we can also expect them to develop over time measurement systems for the types of risks which are not covered by the present Accord, such as interest-rate risks in the banking book, settlement risks, operational risks, legal risks, IT-risks, physical risks, reputational risks etc. Clearly, a «one-size-fits-all», standardised approach will not be suitable for sophisticated global firms. Credit risk models will have to be admitted in due course, provided they still produce enough capital and are not merely limited to the easy part of the banking book where reliable market-data and external ratings are available.

4. How should we tackle the problem that not all the above mentioned risks can yet be quantified and factored into a model and that we still need to have some common denominator between the individual internal models? The answer could be a bottom line in the form of a base requirement. The base would consist of a very simple set of readily understandable rules, such as the fixed costs of the previous year (e.g. in the EUCAD for non-bank securities firms), a gearing ratio based on the balance sheet or insured retail-deposits, contract volumes etc. Tim Shephard-Walwyn and Robert Litterman have presented their «base plus approach» at the New York FED conference in February 1998, which combines the base requirement with an additional amount of capital based on the output of the firm’s own internal risk measures, taking

3. This opinion was clearly stated by Dr. Kurt Hauri, Chairman of the Swiss Federal Banking Commission, at the Commission’s annual press conference of 21 April 1998.

4. Risk-reducing techniques or multilateral clearing and settlement institutions such as the planned Continued Linked Settlement Services would benefit from a preferential treatment.

5. The results of a recent survey of the Basle Committee indicate that most banks are only in the early stages of developing a framework for measuring and monitoring operational risk, but banks appear to be taking interest in how some insurance risks are measured as possible models for operational risk measures.

into account the results not only of VaR-models but also the results of stress tests and scenario analysis. In any event, we need a *capital cushion for non-quantifiable, yet unknown or simply underestimated risks*.

5. Pleading in favour of a special regime for core institutions, logically implies *differential supervisory standards*. To some extent we have already taken this road with the market risk amendment of the Capital Accord, by offering banks a choice between the Standard Approach (including a «de minimis» exemption for small trading books and several alternatives for the treatment of options-positions) and the Models Approach. In their internal organisation several supervisory authorities – e.g. the Nederlandsche Bank, the UK Financial Services Authority and the Swiss Federal Banking Commission – have created special units for the ongoing supervision of big, complex banking groups, recognising that in practice we are dealing with very different animals. We could now go all the way and create a *two-tier or multi-layered regulatory system*, at least for capital adequacy purposes: one for systemically relevant core institutions and one (or more) for middle-sized and smaller banks.

6. The attractive advantage of a two-tier (or multi-layered) system would be that we could essentially maintain the 1988 Capital Accord (including the subsequent amendments) and possibly even simplify it for the *lower-tier banks*. Especially smaller and middle-sized banks increasingly complain about the complexity of capital regulation and the ever more frequent changes, not because they would need to raise their capital (in most cases, the contrary applies). What they really worry about are the additional resources in qualified staff and IT required for the implementation of rules which were mainly designed for internationally active banks with a more complex activity. Many domestic bankers would prefer simpler rules, even if they resulted in higher capital requirements, or in other words: *back to basics*!. Maintaining the Capital Accord for lower-tier banks would also strengthen its role as a *world-wide standard for non-G-10 countries*. As the Basle Committee's most successful export product for emerging markets, transition-economies and third-world countries, the Capital Accord should be kept simple and understandable. We do not need to send a Ferrari racing-car to countries, where a robust Jeep is the only vehicle which will pass the dirt-roads and which can be repaired by every mechanic.

7. Many of the *refinements* and intricate exercises of *fine-tuning* of the Capital Accord would not be necessary, if they were confined to the upper-tier bracket of globally active banks, who orginate all the creative gadgets (such as asset-securitisation, credit derivatives, structured preferred stocks and instruments with interest-rate step-ups or call options) in order to circumvent a rigid standardised approach. Some international coordination of the implementation process and regulatory responses to new developments will always be required, but it would be facilitated if it was focused on a few dozen global players.
2. PRECOMMITMENT FOR MARKET RISKS

In his thesis⁷, my colleague Martin Sprenger, member of our Models Team, has carefully analysed the pros and cons of the PCA. He concludes that the PCA – despite its inability to prevent imprudent firms from pursuing a «Go for broke» strategy and its potential to increase systemic risks in phases of higher market volatility and pending sanctions – has non-negligible advantages over the rigid rules of the Basle Model Approach, in as much as it creates effective incentives for firms to optimise their internal risk measurement models. Sprenger then develops his own Approximation Approach which is designed to combine the liberal, incentive-orientated concept of the PCA with the more safety-orientated Basle rules.

As a lawyer and regulatory policy-maker, I am not attempting to be as scientifically objective and politically correct with the PCA, at least with respect to capital adequacy for market risks. I instinctively distrust any method which appears to be mainly motivated by an endeavour to further reduce capital requirements. Against the principles for a future capital regulation (chapter 1 above), PCA for market risks does not look attractive from a regulator’s perspective:

1. Since our main concern, at least for core institutions, is with systemic risk, any method which like PCA ultimately increases this very risk, can hardly be our choice. Letting banks bet against supervisors on the appropriate amount of capital cannot be a sound policy, if it is to replace already existing capital requirements. Gambling becomes especially unfair, if one party (namely the bank) is speculating on not having to keep its pledge, because the supervisor prefers not to impose the sanction if he risks to increase the difficulties for the individual bank or if he might trigger a systemic crisis.

2. There is no immediate need to further fine-tune the regulation for market risks. The Basle Models Approach is the most recent piece of regulation which has only been fully implemented in very few G-10 countries⁸. It was explicitly designed to provide incentives for banks to improve their risk management skills and to close the gap between external regulation and banks’ own measurement systems. Under the Basle framework, even a bank with no or less than five outliers in the backtesting results still has ample scope for improvement, because it will only get the minimal multiplication factor of three if all the qualitative criteria are fulfilled to the entire satisfaction of the supervisor. Why then, should we look for even more incentives in the one area which is already far ahead in risk management techniques, which – by the way – had been developed by the industry without sticks and carrots from regulators? Focussing yet

8. The Swiss Federal Banking Commission has given its first full approval for the use of internal VaR models for market risk capital requirements to Credit Suisse First Boston on 1st July 1998. Most European authorities have not even started the approval process because they had to wait for an amendment of the EU Capital Adequacy Directive to incorporate the models approach.
again on market risk in the trading book would be setting the wrong priorities. In the words of Tim Shepheard-Walwyn, this was only the hors d’œuvre; the main course comes with models for credit risk. Hence, the suspicion remains, that the protagonists of PCA simply don’t accept the Basle quantitative parameters such as the multiplication factor of three (plus) and the 10-day holding period because they consider the resulting capital requirements to be still excessive. It would be more honest to admit that the industry would like to reopen the eternal bargaining game instead of disguising it under the ideological concept of achieving the ideal incentive structure.

3. Why should regulators not make further concessions on market risks at this stage? As long as we do not apply capital requirements for the numerous other risks in banking, any fine-tuning on the existing two pillars (credit risk and market risk) will erode the capital cushion for other risks. One might object that every well-managed, prudent firm would always strive to keep enough capital to survive any significant stress event, except the total collapse of the financial system. But under the pressure of the shareholder-value concept and the fetish of ever higher returns on equity, such an exemplary behaviour cannot automatically be expected. It has to be actively promoted by rating agencies and regulators.

4. The sanctions for losses which exceed the precommitted amount are highly problematic. If they were to be applied in a mechanistic, self-executory fashion, they could cause a lot of damage in an already critical situation. If they are waived, the system becomes incredible and invites speculative behaviour.

5. One positive element of PCA has been highlighted: it is result-orientated, if implemented consequentially. Under these conditions, it would not matter, if the cause of the losses was an underestimation of market risks in the trading book or any other failure due to settlement, operational or legal risks associated with the trading activity. In order to avoid a breach of the precommitted amount, the bank would thus have a stronger incentive, to identify, limit and control such risks which are still hard to measure and quantify. But then we have to ask, whether we really need a precommitment to achieve such a result? Under the existing regulation in most countries it is irrelevant from which source or cumulative sources a bank has suffered a loss, even if the capital rules only explicitly cover credit and market risks. If a bank under Swiss banking law, for whatever reason, does no longer meet the overall capital requirements, it seriously violates the law and risks the withdrawal of its banking licence and compulsory liquidation, should it not restore the rightful conditions within a very short time (Art. 23quinquies Banking Act). This death-penalty is certainly a more effective deterrent than a fuzzy precommitment limited on market risks in the trading book. In any case, the guiding principle for any supervisory measures has to be the concept of proportionality.

3. PRECOMMITMENT FOR OTHER RISKS?

The idea of a PCA looks more attractive from the regulator's perspective for risks which are not yet covered by the existing Capital Accord. This could be a laboratory for experiments on the measurement of different risk categories where significant progress can be expected in the nearer future. Or in other words, it would be a mechanism for firms to demonstrate to the supervisors how they allocate internal capital and to give the necessary reassurance that the aggregate amount of capital which a firm has is sufficient relative to the risk that the firm is facing. And then we would come to the «base plus» approach of Tim Shepheard-Walwyn and Bob Litterman.

What would be the attraction for well-managed, sophisticated firms? Why should they precommit a certain amount of capital and possibly face sanctions for risks which the supervisors have not yet covered with a prescriptive capital adequacy regulation? The answer is simple: to avoid the regulatory sledgehammer for the newly identified risks and to convince regulators to accept credit risk models or a refinement of the Capital Accord without eroding the overall capital cushion. Because in my personal view, it would be inconceivable to allow e.g. the 100% risk-weighting for claims on non-bank private sector borrowers in the existing Capital Accord to be replaced by a differentiated weighting (possibly based on internal ratings), without getting something equally substantial in return. Finally it seems equally obvious, that the regulators should never accept the PCA for credit risks. They are a too serious matter, to be played around with or betted on.