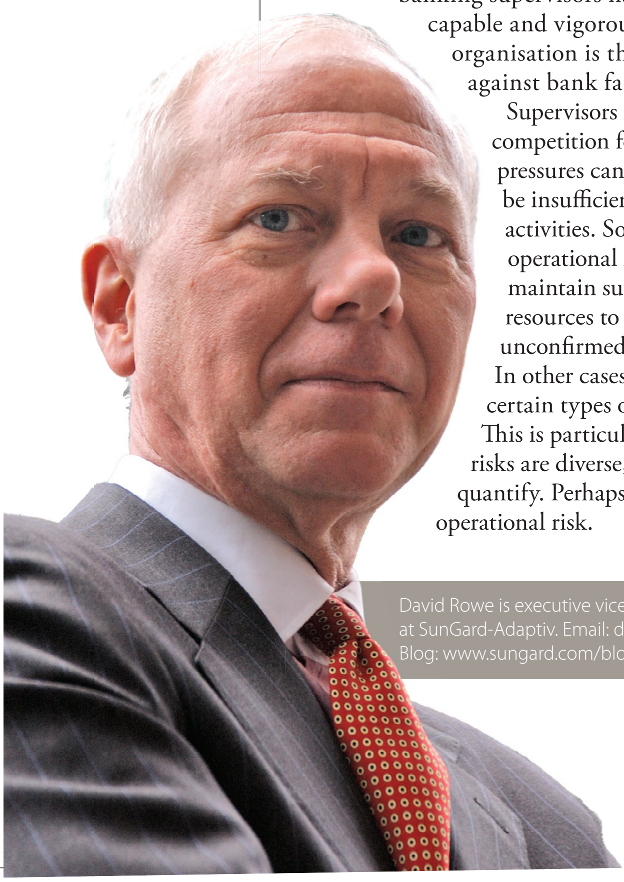
A dangerous idea

Encouraging and supporting sound internal risk management has become an important aspect of effective financial regulation. Imposing a regulatory capital charge for stress-test losses would undermine this important objective, argues ***David Rowe***

The Basel Committee's 1995 decision to allow use of internal models for calculating regulatory capital marked a significant departure from the traditional 'we know best' attitude on the part of regulators accompanied by detailed prescriptive rules. Consultation with industry risk practitioners convinced supervisors that the world was becoming too complicated and changing too fast for the old paradigm to assure safety and soundness of the banking system.

A significant aspect of the new supervisory approach has been to require and support a strong internal risk management culture. Evaluation of the experience and training of risk management staff, the resources available to them and their independence in the organisational structure has become an important element of supervisory review. In effect, banking supervisors have come to realise that a capable and vigorous internal risk management organisation is the crucial first line of defence against bank failure.

Supervisors have also recognised that competition for resources and bottom line pressures can lead to what they consider to be insufficient attention to certain activities. Sometimes these relate to operational lapses, such as the failure to maintain sufficient system and staff resources to prevent a major backlog of unconfirmed credit derivatives transactions. In other cases, this has occurred relative to certain types of risk management analysis. This is particularly common in areas where risks are diverse, amorphous and difficult to quantify. Perhaps the best example of this is operational risk.



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Early in the Basel II deliberations, the Basel Committee decided to include an explicit operational risk capital charge. This might have started as nothing more than a means of offsetting a likely decline in regulatory credit risk capital resulting from greater recognition of diversification benefits. But it quickly began to force banks to get serious about many of the process-discipline lessons that manufacturing firms had learned so painfully in the 1970s and 1980s.

Some banks lobbied to eliminate the explicit capital charge and force operational risk back into supervisory oversight under Pillar II. I applauded the Committee's determination to maintain operational risk in Pillar I, despite our obviously limited ability to quantify it accurately. There is no question in my mind that vastly more resources have been devoted to improve process controls than would have occurred without the imposition of an explicit capital charge. Some will question the cost/benefit trade-off involved, but I believe the financial system is notably safer as a result.

More recently, the Committee has focused attention on another amorphous risk issue – stress testing. In paragraph 778(iii) of the June 2006 comprehensive version[1] of the proposed Accord, the Committee states: "A bank must ensure that it has sufficient capital to meet the minimum capital requirements... and to cover the results of its (required) stress testing... To the extent that there is a shortfall, or if supervisors are not satisfied with the premise upon which the bank's assessment of internal market risk capital adequacy is based, supervisors will take the appropriate measures. This will usually involve requiring the bank to reduce its risk exposures and/or to hold an additional amount of capital, so that its overall capital resources at least cover the Pillar I requirements plus the result of a stress test acceptable to the supervisor."

The Committee has chosen its words carefully. The assessment of capital adequacy to cover stress-test losses is a Pillar II evaluation of *internal* capital. It is *not* part of the Pillar I calculation of minimum regulatory capital. Nevertheless, some banks fear that proposals for inclusion of a Pillar I charge to cover stress-test losses might emerge. This would be a dangerous idea.

While I agree that such a charge was a necessary prod to force greater focus on operational risk, the situation is quite different for stress testing. Most particularly, stress testing is an exercise in imagination. Effectively, it involves thinking the unthinkable, or at least the highly implausible, and assessing the possible impact of such events and how best to counter them if they should occur.

Tying an explicit capital charge to the losses from such an exercise would clearly constrain people's imaginations. Doing so would undermine much of the internal risk management benefit that greater attention to stress testing is intended to produce. Let us hope the fear of a Pillar I capital charge for stress-test losses remains purely hypothetical. ■

[1] *Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version, June 2006*