Two cheers for the regulators

Allowing internal models for market risk capital was a big, bold step by the regulators. But, David Rowe argues, the downside was a reduction in comparability between internal model and standard model users

At the end of this month the comment period will close on the Basle Committee on Banking Supervision's proposal to revise the 1988 Capital Accord. This comment process highlights the tension that exists between government regulators and the private institutions they regulate. Rather than dwell exclusively on this tension, however, it is worthwhile taking a step back and considering how far we've come in recent years.

While tension is inevitable between regulators and the institutions they regulate, that tension can be healthy or destructive. In many parts of the world, unfortunately, government officials are not viewed as public servants but as acquisitive entrepreneurs in their own right. In such a context, bribery and corruption are rampant, to the severe detriment of the general public.

One of the great achievements of some modern societies has been to subject government officials themselves, including regulators, to the rule of law. This makes their actions subject to judicial review and prevents unrestrained prerogatives of government officials from being viewed as the surest road to riches. One of the most consistent lessons of history is that human beings inhabit a moral space somewhere between the brutes and the angels. For better or worse, a judicially accountable regulatory regime is the best method yet devised (or likely to be devised) to counter the inevitable larceny that lurks in the human soul.

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Conflicting priorities

One of the essential requirements of a sound regulatory regime is effective review and oversight at all levels. At the institutional level, this takes the form of verifiable disclosure of relevant activities. Access to some of these disclosures is limited to the regulatory authorities while others are appropriately available to the general public. In either case, two desirable characteristics of such disclosures are usefulness and comparability. Unfortunately, there is significant tension, if not outright conflict, between these two objectives. Usefulness is best served by customising disclosure reporting to the specific activities of each institution. Inevitably, however, this undermines the comparability of such reports across institutions.

In an earlier and simpler time, this tension was less intense. Standard reports, such as the bank call report, gave a reasonable picture of any one institution's activities and these were neatly comparable across institutions. Over the past 30 years or so, the nature of banking and finance has become dramatically more complex and more varied across institutions. This, in turn, has intensified the conflict between usefulness and comparability. As recently as 1993, senior regulators were still focused primarily on comparability over usefulness. The original BIS Market Risk Capital Proposal[1] called for a simple duration- and volatility-adjusted slotting of assets and liabilities into pre-defined buckets to capture net open position risk. Then there was an arbitrary disallowance scheme to assure some capital requirement for basis risk that might exist, but which the proposed methodology was too crude to capture. In the words of a response I was instrumental in drafting: "When compared to the internal control systems used by major dealing banks for managing the market risk of their trading books, the proposed analysis is many years and an order of magnitude out of date."

In essence, comparability had trumped the fact that the proposed reporting scheme was not an accurate reflection of risk at any given institution.

Two cheers

To their considerable credit (I always felt I saw the wise influence of my old boss Alan Greenspan in this), regulators reacted positively to the outspoken industry criticism of the original market risk capital proposal. They recognised that internal risk control models had progressed much further than had been previously realised. The result, of course, is the regime in effect since January 1998, in an amendment to the 1988 Capital Accord that allows internal risk models to be used for calculating market risk capital requirements, subject to review and certification by the regulators.

The move to allowing internal models for market risk capital was a big step forward by the regulatory community. It represented a major and rather brave departure from the philosophy of the past. For making this step, regulators deserve more commendation from the business community than has been generally forthcoming, hence my "two cheers".

Why only two cheers, however, and not three? In my view, recognising internal models for market risk entailed only a modest conflict between usefulness and comparability. Comparability was sacrificed if one wanted to compare banks using the standard model with those using internal models. On the other hand, comparability was well preserved, perhaps even enhanced, when analysing multiple banks using internal models. This was because value-at-risk (with a stipulated time horizon and confidence level) offered a convenient and meaningful metric for comparison.

In addition, the resulting internal model disclosures were more useful for analysing any given institution than the standard model results would have been. In essence, some comparability was lost (across internal model and standard model users) but considerable usefulness was gained in the reporting of internal model banks. On balance, this could be viewed as an attractive trade-off.

Unfortunately, using internal models for calculating credit risk capital presents a more serious conflict between comparability and usefulness than was true for market risk capital. Why that is so, and its implications for progress in this area, will be discussed next month. ■

[1] Measurement of banks' exposure to interest rate risk, *Basle Committee on Banking Supervision, April 1993*