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Market and Risk Management Innovations: Implications for Safe and Sound Banking

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The paper by Fred Furlong and Simon Kwan (2007), "Safe and Sound Banking Twenty Years Later: What Was Proposed and What Has Been Adopted," is a comprehensive discussion of the status of recommendations that first appeared in *Perspectives on Safe and Sound Banking* (Benston et al. 1986). Summarizing the recommendations that appeared in a book twenty years ago and providing an overview of all the actions taken related to those recommendations could easily have become unwieldy. Fortunately, Furlong and Kwan have been quite successful in succinctly covering the many regulatory and supervisory changes over the past two decades that have responded (or in some cases not responded) to the original recommendations.

One of the major themes highlighted by Furlong and Kwan is the surprising number of recommendations from *Perspectives on Safe and Sound Banking* that have been adopted during the past twenty years. My comments provide a brief overview of three of the major innovations that were suggested in the original recommendations and discussed by Furlong and Kwan: movement toward greater risk-sensitive approaches, an enhanced role for market discipline and disclosure, and earlier intervention for troubled banks. I will then discuss the environmental changes that may not have been anticipated at the time of the original recommendations and some implications for bank supervision and regulation. The final section will provide some conclusions.

Major Innovations since the Publication of *Perspectives on Safe and Sound Banking*

One of the major suggestions in the original report was that bank supervision and regulation should adopt more risk-sensitive approaches. During the past twenty years, bank regulators have increasingly adopted risk-sensitive regulations. Perhaps the most striking example was the adoption of more risk-sensitive capital regulation. Basel I took some initial steps toward greater risk sensitivity by creating varying capital charges for asset classes according to their credit risk. While these asset categories were quite broad, they started the process of varying capital according to the riskiness of the bank. The Basel II proposal takes the risk sensitivity much further by allowing capital to vary according to the credit, operational, and market risk of the bank. In addition,

Basel II is a far more granular approach and comes much closer to the economic capital approaches taken by banks when they allocate capital internally.

Much of the Basel II proposal has leveraged off innovations made in risk management within the banking industry. As banks have become more complex, it has become increasingly important for institutions to develop their own internal models to calculate risk and return internally. An institution's corporate decisions, such as stock buybacks and dividend payouts, as well as internal decisions such as which business lines should be allocated more capital, require a much better understanding of the bank's capital and risks. The risk-sensitive approaches used in economic capital have served as the foundation for the new Basel II proposal.

Deposit insurance premiums have been another area where more risk-sensitive approaches have been adopted. The Federal Deposit Insurance Corporation has recently implemented a risk-sensitive approach to insurance premiums. While an appropriate policy, the impact of this approach is likely to be modest.

Bank supervision is another area where risk-sensitive approaches have been adopted—again, in response to industry innovations. Most banks use risk-sensitive approaches for internal audit and risk function activities. Similarly, bank supervisors have looked for opportunities to be more efficient by allocating more resources to those institutions that pose the greatest risk.

A second major innovation is a greater role for market discipline and financial disclosure. A variety of factors have caused banks to reexamine their degree of disclosure. Potential legal risk from not disclosing material information has caused banks to become more proactive in disclosing supervisory issues such as board resolutions and memorandums of understanding. Many institutions have been exploring innovative ways to disclose key control issues and better inform investors about their risk management practices. Improved disclosure has also been an outgrowth of the increased accountability of boards of directors. From a regulatory perspective, the Basel II proposal includes market discipline and improved disclosure as a central pillar.

A third major innovation is the acceptance of the benefits of earlier intervention into problem institutions. Perhaps the most important was the adoption of prompt corrective action, which required bank supervisors to close banks well before they had exhausted their capital. This innovation has given clear directions to bank supervisors that they are accountable for closing banks promptly as they become more troubled and that forbearance is not consistent with their legislative mandate.

A number of other innovations have resulted in problems at banks being addressed before the problems become severe. First, the emphasis on greater involvement by directors has caused them to get much more involved when significant problems are identified by internal audits or bank supervisors. Second, bank supervisors are more proactive in elevating problems. Memorandums of understanding, board resolutions, and formal actions are often imposed on banks that remain well capitalized. This approach emphasizes that interventions are occurring well before problems become a significant capital problem. Finally, at large banks, continuous supervision avoids discontinuities between exams. Exam teams that receive internal memos and board minutes and are in frequent contact with managers throughout the bank are much more likely to identify problems early compared to the more traditional periodic exams that are still conducted for smaller institutions.

Environmental Changes

While *Perspectives on Safe and Sound Banking* foreshadowed many of the changes to occur over the ensuing twenty years, obviously many of the environmental changes

that occurred in banking could not have been fully anticipated. One unforeseen change is the increased awareness of the role of financial institutions in the resilience of markets. Perhaps the most striking example of this was the 9/11 attacks, which had a significant impact on institutions in close proximity to the World Trade Center. The ramifications of the attacks increased awareness that business resilience was increasingly important. Banks have responded by significantly enhancing their contingency planning, and regulators have issued a white paper on business continuity for key market players.

The recent work on improving the functioning of the credit derivatives market is another example of the role of financial institutions in markets. This market has become increasingly important to banks and other financial institutions seeking to hedge some of their credit risk. However, the back-office developments have not kept pace with the volume of activity, and failed trades could potentially disrupt this market. Joint efforts by regulators and banks have been instrumental in reducing the volume of failed trades.

The Federal Reserve has also become much more aware that the volume of activity during the day could potentially result in significant intraday exposures to a failed bank. Both banks and the Federal Reserve have been taking actions to reduce the potential for such exposures, which could potentially disrupt the payment system.

Another major development is the emergence of processing banks, which often have negligible loans and retail deposits but are key players in settlement activities. With trillions of dollars in assets under custody and assets under management, these institutions are key players in the infrastructure of the financial system, and they pose potential systemic concerns from sources other than deposit runs. Unlike most other banks, processing banks tend to have relatively little credit risk exposures but have potentially large operational risk exposures.

While *Perspectives on Safe and Sound Banking* recognized that fraud was potentially an important source of bank failure, the definition of operational risk has expanded well beyond traditional fraud. Recent data from twenty-three large U.S. institutions show $25.9 billion in operational losses. These losses were dominated by two causal types: 78.9 percent from legal losses and 9.6 percent from execution and process errors. The legal losses frequently occur when new financial products carry risks that are not fully appreciated. This practice can result in class-action lawsuits for misleading customers or providing products that are not appropriate for their corporate clients. Process errors can occur when banks do not fully understand the risks posed by sloppy backroom operations. Mitigation for these types of problems is very different than the traditional controls placed in a bank to prevent internal or external fraud.

Another major innovation is the emergence of truly global banks with a variety of legal entities around the world. While most of *Perspectives on Safe and Sound Banking* had a domestic focus, the emergence of trillion-dollar banks is causing changes that were not fully anticipated. Although global banks have corporate governance, risk management, and economic capital determined for the entire enterprise, most regulation and supervision of institutions is based on legal entities operating within a national border. For example, bank regulations and supervision of institutions are focused on legal entities within national borders, the discount window is focused on domestic activities, and most deposit insurance schemes are focused on domestic deposits. This problem may be exacerbated as some trillion-dollar banks become large relative to the home and host countries in which they operate. Over time it will be necessary to more fully consider whether global banks are compatible with the national focus of most of our supervision and regulation of these entities.

Conclusion

While the recommendations in *Perspectives on Safe and Sound Banking* have not been fully implemented in the ways suggested by the authors, the original book helped generate many positive developments that are consistent with the spirit of their recommendations. Furlong and Kwan have done a nice job of summarizing the book and its impact. While much has been done in the past twenty years, spurred on by academics who have advocated more risk-sensitive market-based solutions, there is no shortage of additional issues that need to be tackled.

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