

COMMENTARY

I would like to start by focusing on the method and model used in the paper by Jean-Charles Rochet. In particular, I will consider some of the paper's assumptions. This discussion will bring me to some specific remarks on Basel II, after which I will circle back and comment on Rochet's policy conclusions.

I found the Rochet paper to be interesting, and I liked it very much. Speaking as a bank supervisor, I believe there is a clear need for more research in this vein, which as I see it is an effort to make the theoretical models of banking and bank supervision more realistic in various ways, thus in part to make their conclusions more influential. Most of the value I can add with regard to the model therefore is to focus on the assumptions that still seem somewhat at odds with what the world looks like from a bank supervisor's perspective.

Foremost is probably the fact that the true economic value of a bank's assets is not known with certainty. I believe the uncertainty associated with this economic value is qualitatively different than assuming that the assets' liquidation value would be less than their economic value. This is part of the uncertainty, but not all of it. Obviously, there are some who believe that this problem should be addressed in practice by requiring mark-to-market accounting for banks. For those who follow accounting developments, moves in this direction by the International Accounting Standards Board—in particular, International Accounting Standard 39—have been receiving a great deal of attention. My only comment on this topic is to suggest that developing a fair-value accounting

approach for the entirety of a bank's balance sheet in the absence of liquid market prices for many of its assets is a challenge of the same—or possibly even greater—order of magnitude as the problem of the first pillar of the Basel II framework.

A second and closely related issue is the fact that the volatility parameter, σ , that governs the underlying stochastic process for the bank's asset value is itself unlikely to be known with certainty. Importantly, this uncertainty is not limited to outsiders. In considering models that are meant to apply to the largest global banks—which clearly has been a primary focus of Basel II—an important issue that must be grappled with is the sheer size and scope of the banks' activities. For example, Citigroup has about 250,000 employees throughout the world. A critical risk management challenge for such a firm is simply to make sure that the head office receives accurate information on the activities of all its operations and that it has a plausible mechanism for seeking to actually influence the risk level of these disparate units.

In other words, I would argue that it takes considerable effort and discipline just to ensure that the level of a bank's risk is transparent and controllable by insiders, much less outsiders. These points also lead me to conclude that the agency problems within large financial firms are absolutely critical to a complete understanding of how they should be managed and supervised. Moreover, if one looks at the list of financial scandals in recent years, it is clear that internal agency problems leading to

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excessive risk taking by the overall firm in a manner that was not transparent to its own top management has played a key role in a number of these scandals.

Thus, I would propose an alternative interpretation of “shirking” to the one presented by Rochet: a bank is shirking when it fails to invest sufficiently in risk management and control systems and thus is unable to identify or control its overall level of risk properly. This leads it to make “bad” investments in the sense that such investments would not have presented an attractive risk–return trade-off had the bank accurately assessed the risk involved. It is not clear to me whether this change in interpretation would lead to a change in the model’s results, but it would be interesting to see.

I now turn to a discussion of Basel II, of which I have been a major participant and am therefore likely to be guilty of bias. Perhaps I have a unique view of Basel II and of capital requirements in general. To me, the essence of the project is the development of a largely comparable and comprehensive measure of risk, particularly credit risk. I believe that the approach to credit risk management is changing fundamentally, as demonstrated by the rapid growth of credit risk transfer markets involving participants other than banks. I do not think that we are likely to see a return to the days when global banks measured their credit risk by rules of thumb.

I believe that the need for a measure of credit risk that achieves greater comparability and greater comprehensiveness than the Basel I measure is of importance to supervisors and to the marketplace generally. Regardless of the outcome of the Basel II effort, I am convinced that something along these lines is both necessary and inevitable. In my view, common tools and a common vocabulary for expressing risk will be significant aids to the development of more liquid markets for the trading of credit risk. In this sense, it is reasonable to think of the supervisory development of the first pillar of Basel II as an effort to solve a marketwide collective action problem related to the development of a common measure of risk.

In addition, the prospect of Basel II is spurring significant investment in risk management by global banks. Many banks have obviously developed sophisticated risk management tools and approaches, but the level of rigor that has surrounded these calculations and the degree to which data have been retained to check and improve the accuracy of these systems are not where they need to be, given the scale and importance of these institutions.

There are two fundamental trade-offs at the heart of Basel II. The first trade-off is between flexibility and comparability. The second is between risk sensitivity and complexity. There is no easy answer to either of these trade-offs; veering too far in either direction has its costs, and there is no doubt that the resulting proposal lacks the formal elegance of the best

economic models. But we are not designing an economic model. Rather, we are working to improve steadily the risk management capabilities of those financial firms in which significant weakness would no doubt be quite costly, and we are seeking to establish a considerably better overall measure of the risks taken by such firms. In undertaking such a project, I think there is no better alternative than a highly transparent and consultative process. The balances achieved on the aforementioned trade-offs reflect the outcome of this somewhat messy, time-consuming process.

The result will be far from perfect, but I believe quite strongly that it will be better than what we have today. In particular, one way in which it will be better is by providing a shared signal to supervisors, the market, and bank management that credit quality is deteriorating. The current framework essentially embodies no such signal and puts the onus on the reserving/charge-off decision instead. A risk measure that responds dynamically to changes in credit quality has the potential to alert bank management, supervisors, and others to emerging problems much more quickly than before. Like Rochet, I believe that a key focus of supervisory policy should be on designing frameworks that discourage forbearance and create incentives for addressing problems promptly.

As to the topic of Pillar 3 and market discipline, I must take issue with Rochet’s assessment based purely on “page count.” Indeed, I believe that at the heart of Basel II is the development of a risk measure. Step one of Pillar 3 is therefore disclosure of this risk measure, on which basis it would not be unreasonable to assign to Pillar 3 all of the pages devoted to Pillar 1. But this is a quibble. The key fact is that Pillar 3 of the Basel II proposal does not stop there. It requests disclosure of a number of other items that focus on credit concentrations, the components of bank capital, and other more detailed breakdowns of risk by portfolio. This is intended to provide greater and better information—more frequently—to market participants. Importantly, the current version of Pillar 3 reflects significant consultations and interactions with market analysts over what information they would like to have that banks are reluctant to provide willingly.

In this regard, it is worth emphasizing the point that determining what sort of information is most useful to disclose is not a trivial problem, particularly if the concern is to gauge in a forward-looking manner the risk to which a complex firm is exposed. Many of the analysts that I have spoken with have expressed some frustration with finding suitable ways to assess this risk on the basis of current financial statements. Personally, I wonder if this frustration has in some way been responsible for what appears to have been an overemphasis on the stability of reported earnings by some market analysts.

In any case, I believe that trying to make publicly available better measures of firm risk is a critical part of trying to make market discipline more effective. I also believe that this is a potentially fruitful avenue for empirical research on, for example, the types of risk disclosures that would be the most useful indicators of true underlying risk.

I now turn to two of the policy conclusions of the Rochet paper. First is the conclusion that market information can be a useful tool in allocating scarce supervisory resources. This is not seriously disputed by anyone I am aware of. In the United States, bank supervisors are extensive users of information such as stock prices, debt spreads, KMV, and market costs of credit protection. This information helps inform the allocation of our supervisory resources. Although I should add that here at the New York Fed, we have long sought to have extensive direct market contacts in an effort to ensure that we are not behind those markets in terms of their views of key participants.

More broadly—and with several recent cases in mind—I believe that there has been a marked increase in the intensity of supervision that has occurred simultaneously for those firms that have seen their market spreads widen significantly. But from the perspective of academic research, I know that the question is, Why has there not been a greater effort or willingness to develop approaches that “hard-wire” supervisory reactions to market signals, in particular, the subordinated debt proposals that have been made?

In the United States, there has been extensive discussion and research on this subject, such as the Treasury/Fed study mandated by the Gramm-Leach-Bliley Act. In many other countries, I honestly think there has been somewhat less enthusiasm. I believe this reflects concerns about giving up control as well as concerns about whether the underlying market signals are fully reliable—that is, that market prices may reflect excess volatility. But the concept has not been ignored, and I believe the supervisory community wants to see more research. In this regard, I commend to you a recent working paper by the Basel Committee’s research task force that discusses the existing markets for subordinated debt in the G-10 countries. The paper is available on the Bank for International Settlements’ website.

Specifically with regard to subordinated debt, my own concerns have always centered on the idea that the proposal is premised on the creation of a liquid market in a product that does not seem to be desired today in the quantity and frequency that some of the models imply are necessary. In addition, there is the observation that the subdebt holders have become the “de facto regulators” of the bank in various ways. But if that is truly the case, then again, as some recent scandals suggest, we need to worry significantly about the potential conflicts of interest between the de facto regulators and the regulated.

We need to ensure that banks are not simply buying and holding each other’s subdebt in quid pro quo arrangements. We need to be able to police potential conflicts of interest between asset managers and the banks that provide custodial services for those asset managers. I do not believe that this would end up being so simple in practice.

However, the future may be brighter for credit derivatives. A downside is that these derivatives are typically written on senior debt. But the upside is that a relatively liquid market with standardized terms is emerging in which contracts on the largest global banks are among the most active products, in particular, to help these firms manage their counterparty risks with each other. Moreover, in the past six months, we have seen credit derivative index products grow significantly, potentially enabling the marketwide signal to be disentangled from the firm-specific signal. Again, I would suggest this as a fruitful area for empirical research that explores the possibilities of linking supervisory intensity or even specific supervisory actions to these market signals.

The second major policy conclusion I will discuss is the need for a greater focus on the harmonization of supervisory practices around the world. Again, this idea has a lot of appeal. In the United States, I think it is fair to say that the supervisory community generally believes that it does a reasonably good job on Pillars 2 and 3. In regard to Pillar 2, the view of U.S. supervisors is that the primary responsibility is for bank managers to determine what their desired level of capital is and how they want to allocate that capital, but that supervisory interaction—which benefits from having a window into the practices of a number of the major banks—with banks on those decisions is advantageous.

Frankly, a major part of the original U.S. impetus for Basel II was to help export our preferred supervisory concepts and approaches more broadly around the world. For example, we believe that a mix of supervision and regulation works better than a purely regulatory approach with little on-site presence. I believe that, in large part driven by the realities of their responsibilities under a Basel II regime, many other supervisors have been moving toward us in approach, in particular, in the view that quality supervision requires substantial investment in skilled staff with the ability to understand modern risk management methods.

Changing embedded institutional arrangements and eliminating political pressures will not happen overnight. Realistically, efforts to harmonize supervisory approaches should not be seen as a substitute for Basel II. From a practical perspective, a successful resolution to the Basel II negotiations will enhance the Basel Committee’s pursuit of further efforts to increase supervisory cooperation and converge supervisory methods.

In conclusion, I agree very much with Rochet's view that focusing more attention on supervisory practices and on market discipline would be extremely worthwhile. Further efforts to harmonize and improve supervisory practices globally are desirable. However, I do not share the author's opinion that the Pillar 1 project is sufficiently unimportant that

it could or should simply be abandoned. As I have said, the development of better risk measures is both necessary and inevitable. It is indeed largely inconceivable to me that the global capital markets could continue to develop over the next ten or twenty years in a way that avoids the need for such comprehensive and comparable measures of risk.

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