

Regulators Line Up Behind Economic Capital

Peter Nakada

Economic capital is about to become even more important in the regulation of US financial institutions. At least, that was the message of leading regulators from the Federal Reserve Bank of New York (FRBNY) at a major conference¹ in mid-January.

William R Rutledge, EVP in charge of FRBNY's Bank Supervision Group and a member of the Basel Committee on Banking Supervision, said that economic capital is becoming more important because of the Gramm-Leach-Bliley Act, and because the capital charge mechanism in the new Basel Capital Accord is continuing to evolve.

For some time, economic capital has been regarded as a key concept by risk researchers. It is best defined as the amount of capital required for an institution to achieve its target financial strength². In the late 1990s, the use of the measure spread from leading-edge banks to mainstream financial institutions of various kinds as they tried to improve a range of business decisions, including risk-based pricing and profitability analysis across business lines. But only more recently has it begun to become a prominent part of the language of bank regulation.

Rutledge spelled out the two reasons why economic capital will rise even further up the regulators' agenda in 2002:

- The Gramm-Leach-Bliley Act of 1999 allowed banks that set up financial holding companies to branch out into non-bank business opportunities, provided they could convince Fed supervisors that they have enough capital available to support both their bank and non-bank activities. That's a question that the Fed says must be addressed within the common currency of an economic capital framework; and

- The evolution over the past year of proposals for minimum capital requirements under the new Basel Capital Accord.

With regard to the latter, ERisk has watched with interest as the global banking industry has secured concessions to the internal ratings-based framework for calculating credit risk capital. The industry has also persuaded the international regulators to reduce the new capital charge for operational risk. It seems to us that the weaker the rules-based regulatory capital charges, the more strongly Fed supervisors will insist that US banks use economic capital models to assess their financial strength under the new Basel Capital Accord.

Rutledge suggests this is a healthier direction anyway, because rules-based systems such as the minimum capital requirements inevitably tend to lag business practices. (New business practices such as credit securitization and the growth in sub-prime businesses have proved a headache for US regulators in the present economic cycle.)

Other speakers at the January conference admitted that both regulators and the industry are on a learning curve about economic capital. It's a task the regulators first committed themselves to when they published their seminal SR99-18 rule in July 1999³. This document explicitly applied economic capital concepts to the regulation of those banks that the Fed classified as "large complex banking organizations", and those that engage in significant derivatives and off-balance sheet activities.

The list of banks that the Fed thinks falls into this category has grown to include perhaps around 50 banks. It seems likely most banks with over \$10–20 billion in assets will eventually fall into the net. So far, the Fed has not strictly and consistently applied the economic capital concept to the risk of all these institutions. But recent efforts to educate supervisors, such as the January conference, suggest this is about to change.

The key contribution of economic capital is that it offers a common currency that allows management to link risk to strategic and tactical business decisions. But increasingly it also offers a common currency between business and regulatory thinking about risk. For both these reasons, the economic capital movement has profound implications for institutions of all types and sizes.

Peter Nakada can be contacted on telephone number 917 522-1603 and by email at pnakada@erisk.com



Peter Nakada
Head of Consulting

¹ Federal Reserve Bank of New York's Economic Capital Conference, for banking supervisors, January 8-10, sponsored by the Fed's Economic Capital Competency Center.

² This is referred to as a bank's 'solvency standard' and is measured in terms of the probability of the bank's losses exceeding its capital.

³ This document can be accessed via the additional resources page for this report at www.erisk.com/report

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ERisk, 1155 Avenue of the Americas, New York, NY 10036, USA
Tel: 212.819.0170
Fax: 212.819.0171