Prescription **vs.** principles

Over the past decade, the shift of supervisory practice from prescription towards a principles-based approach has been dramatic. This was a valuable and necessary change, but it has also greatly complicated retaining qualified supervisory staff, argues ***David Rowe***

Today, we frequently hear complaints about the Basel II rules being too prescriptive. In that context, it is worth remembering how far we have come in just over a decade. I have long felt that April 1995 should be recognised as a historic point in the evolution of financial sector regulation. It was in that month that the Basel Committee on Banking Supervision published its decision to allow banks to use their internal risk models as the basis for calculating minimum regulatory capital for market risk.[1] It is now hard to recall what a sudden, even daring, change this was.

At the time, some viewed this decision as a concession by supervisors to the banking industry. Certainly most of us who were developing and implementing market risk systems were delighted. We would not be forced to divert resources towards maintaining a series of prescribed regulatory calculations of little practical value in our day-to-day oversight of market risk. Instead, we could devote all our efforts to deploying the most effective market risk measurement techniques consistent with our individual trading activities.

In the end, of course, there was a quietly articulated addendum to the allowed use of internal models that has proven just as significant as the decision itself. This was the expectation that banks would, going forward, adhere to 'best practice' risk management methods. Needless to say, best practice is a constantly moving target. In effect, supervisors minimised their traditional role in defining detailed reporting procedures and took on a new role as the overseer and judge of competing methods developed by banks themselves. Given the pace of innovation in financial markets, this has proven to be a shrewd strategy. It allows supervisors to see evolving methods across many institutions and to encourage the spread of the most effective techniques.

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Attendant problems

Like any change of this magnitude, the supervisory shift away from prescription towards evaluating alternative risk methods and promoting adoption of the best techniques has engendered accompanying problems. Perhaps the most important of these is the substantially increased pressure on supervisory staff. They need to keep up with rapidly evolving and ever-more complex transactions and to be able to challenge bank trading and risk management staff when necessary. Not only do supervisors need to understand the technical details of valuation and risk management models, but they also need to judge the effectiveness of the risk management process itself.

Some of the notable trading losses in recent years occurred at firms that could demonstrate solid risk modelling and information systems. The problems arose because of a breakdown in the balance of power between line management and risk management staff. In addition to technical competence, supervisors need to be able to establish the answers to many softer questions:

- Are risk managers in a position to challenge trading management effectively?
- Do they have the support of senior management when they do so?
- Does the governance structure have the understanding and supporting information to make sound strategic decisions consistent with the firm's capital base and risk appetite?

Such judgements require practical experience that goes well beyond technical understanding of risk modelling techniques.

This challenge is complicated by the growing difficulty of attracting and retaining experienced supervisory staff. Salaries for such staff will never be comparable to what the best people can earn in the private sector. Different supervisors have emphasised a variety of incentives, including time and financial support for continuing education, internal training and the breadth of experience through exposure to many state-of-the-art institutions, among others.

Inevitably, however, maintaining effectively qualified supervisory staff will be a continuing problem for financial regulators. It is important that financial institutions recognise the critical nature of this issue and offer both political and financial support for their supervisors' efforts to attract and maintain well-qualified staff. Should politicians conclude that regulators are unable to operate effectively in the more complex environment of principles-based supervision, there is the potential for reversion to an intrusively prescriptive approach that would be unwelcome to all concerned. ■

[1] *The original proposal published in April 1993 was a traditional, highly prescriptive framework. It contained various minimum capital requirements for risks that might exist, but which the proposed framework was too simplified to capture explicitly*