# Timothy F Geithner: The changing face of risk management

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the Institute of International Bankers, New York, 9 June 2004

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It is a pleasure to join you today for this meeting of the Institute of International Bankers. The financial institutions you represent play a major role in our financial system. The IIB has played an important part in shaping financial policy in the United States, by reminding us with force and persistence of the impact of our actions on the standards of fairness and equality of opportunity that we strive to maintain.

The U.S. financial system has a number of features that help to make it attractive to participants from all around the world.

The structure of our financial system is characterized by a diversity of channels for financial intermediation, with a relatively larger role for the capital markets and a smaller role for banks, than is true in most other major economies. And we have preserved, despite substantial consolidation, a system that comfortably accommodates the largest globally-active financial institutions side by side with a competitive and diverse array of regional and community banking organizations.

We are very open to the presence of foreign financial institutions, and perhaps as important, have traditionally been very open to attracting non-U.S. financial talent to work in our markets. While the number of foreign banking organizations operating in the US has contracted over the last decade, the overall importance has grown. Foreign banking organizations now account for 45 percent of total banking assets in the United States, up from around 40 percent a decade ago, and they account for a substantial share of total securities underwriting in this market.

Our framework for supervision and regulation is supportive of innovation. Much of the most transforming innovations in finance started in our markets or were adopted more quickly and more broadly here than in many other financial systems. The U.S. system, relative to the model in many other countries, has involved a continuous, risk-focused process of supervision and a strong enforcement mechanism working alongside the supervisory community. In addition, we have traditionally assigned a more important role to market discipline, importantly through a strong disclosure regime, in reinforcing the supervisory regime, than has been the case in other markets.

Our system is successful in matching capital with ideas, in allocating savings to where returns are highest, in creating opportunities for households to better withstand the costs of change and dislocation that are inevitable offshoot of an open and dynamic market economy, and in spreading risk to where it can be best absorbed. The high degree of competition and flexibility that characterize our approach helps drive the pace of innovation, both in new forms of financial instruments and in new ways to manage risks.

No financial system, of course, is without vulnerability. And we face a number of important challenges in making sure our system is as strong as it can to be. But the substantial competition from a diverse set of financial institutions, including a strong presence by foreign financial institutions, is an integral part of what makes our financial system work well. Our system would not be as efficient or as innovative, and our financial institutions would not be as strong, if we were less open or less committed to giving all institutions similar national treatment and equality of opportunity.

I thought I would give you a brief overview of the some of the key challenges we face as supervisors and those that confront the risk management community.

The fundamentals of the present U.S. expansion seem relatively strong, with confidence in its sustainability increasing. As the balance of risks to the outlook have evolved, and the financial markets have built in expectations of a move to less accommodative financial conditions, this is a good time to assess how well the U.S. financial system is positioned to deal with this transition, and to withstand the effects of future stress, if that were to materialize.

From our perspective, the U.S. financial system is in reasonably strong shape. Risk adjusted capital ratios are strong, and earnings have been robust. Non-performing loan ratios are very low - at about one percent on average across the banking industry. The financial markets are pricing risk in exposure to financial institutions at what are still relatively low levels.

Securitization and the rapid growth in credit risk transfer instruments have enabled risk to be spread more broadly. Risk management practices have improved in sophistication and rigor. Firms have made substantial investments in improving the strength and resilience of their technology and systems infrastructure. Payments and settlements systems have stronger safeguards in place. The overall capacity of the system to handle large hedging volume has increased substantially.

Despite the fact that we have experienced a sustained period of accommodative monetary and financial conditions, net credit growth to the private sector has been moderate. The overall financial position of the corporate sector is strong. New household borrowing has grown rapidly, but the broad measures of the ratio of debt service to income remain at a level of roughly 13 percent, and estimates suggest that only a quarter of total household debt is exposed to rising interest rates in the near term. Net credit growth to emerging markets has been moderate relative to past periods. Growth in commercial bank assets has picked up a bit in recent quarters, but remains significantly below the pace of the second half of the 1990s.

As the financial markets have built in expectations of a gradual rise in the fed funds rate over the next two years, financial institutions have had some time to position themselves for an environment of higher interest rates and volatility. There have been adjustments in credit spreads and other risk assets, which in some areas had fallen to historically low levels, but these reversals have been tempered by what it still overall a favorable view of corporate credit fundamentals. And it is worth drawing attention to the fact that the average duration of the mortgage market has increased significantly over the last nine months to the point where the amount of hedging pressure on interest rates related to extension risk is likely to be contained even as interest rates rise.

The fact that these adjustments have begun ahead of any change in monetary policy probably will help diminish the strains in the financial system that might otherwise be expected to accompany this type of transition. Even so, risk managers need to be attentive to, and react appropriately to, the pressures that could emerge following this extended period of low interest rates and a steep yield curve.

The agenda for the supervisory community remains dominated by the following broad priorities:

- We are moving ahead with Basle II to bring a more sophisticated assessment of capital adequacy and risk management techniques to the supervisory framework.
- Our ongoing supervisory examinations continue to concentrate on strengthening the internal management and control infrastructure across the various dimensions of risk management and compliance.
- We are supporting the important efforts underway to better align U.S. and international accounting standards and to improve the quality and integrity of public disclosure.
- We are working to encourage firms to proceed with their investments in greater resilience and geographic range called for in the Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System.
- We continue to encourage efforts to strengthen all aspects of our national payments and settlement systems.
- And we are engaged across a number of fronts internationally to provide a more integrated framework of supervision that better matches the integration of national financial systems and the increased global reach of the largest financial institutions.

As part of our supervisory process we monitor closely the evolution in risk management practice across a broad array of financial institutions. Through horizontal reviews that focus on specific dimensions of risk management, we have a reasonably good sense of where the frontier in risk management practices is across the industry, and understand where the gap between this frontier and average practice is the greatest. The size of this gap in practice can increase in market conditions where competitive pressures and a search for return works to erode discipline.

I thought it might be useful to highlight some of the areas where leading practice is farthest ahead of typical practice. Leading practice does not imply that there is a definitely superior model that we expect all firms to converge to over time. In most of these areas, there is some diversity in what defines the frontier of excellence. We recognize this, even as we encourage firms to put in place stronger and more sophisticated systems more commensurate with the complexity of the risks they are taking.

- *Comprehensive aggregation of credit exposure:* The most sophisticated among large diversified financial institutions have well-developed systems for aggregating credit exposure, with a common methodology and results available relatively quickly, across the full range of transactions and business lines they engage in with a single entity or groups of entities with correlated risks.
- *Stress testing and scenario analysis:* Firms at the leading edge have moved well beyond reliance on "value-at-risk" complemented by stress tests of discrete shocks. They employ stress tests built around more exacting, forward-looking scenarios integrating large moves in a number of variables, more tailored to the risk profile of the firm and current market conditions, and the reactions of other market participants and counterparties.
- *Counterparty credit risk management:* The most sophisticated firms use much more careful and sophisticated approaches for measuring potential future exposure, and they analyze how exposures may respond in conditions of significant market stress. With respect to hedge fund exposure in particular, the leading firms employ comprehensive evaluation of the risk profile of the hedge fund to set credit thresholds and terms and a more disciplined approach to setting sufficiently high levels of initial margin.
- *Measuring and managing interest rate risk:* Leading institutions assess their exposure to interest rate risk in a comprehensive manner across the firm's business lines. The most advanced approaches are able to assess the impact of rate, spread and implied volatility movements under multiple scenarios in both normal and stressed market conditions. These institutions also strive to achieve a balance between shorter term earnings impacts, and the longer-term preservation of economic value.
- *Liquidity risk:* Similar evolution has occurred in liquidity management with leading practice now subjecting dynamic cash flow projections to a range of adverse scenarios relevant to the risk profile of the firm (such as a sustained loss of access to funding or a significant ratings downgrade or a systemic disruption to market liquidity) to assess the impact on funding.
- *Compliance risk management:* Many firms are working to enhance their overall corporate compliance management processes, and the supervisors expect that firms will employ strong risk management practices with appropriate levels of testing. In response to the more exacting requirements of the Bank Secrecy and Patriot Acts and anti-money laundering controls, leading firms have now moved beyond manual systems with very limited capacity to look at patterns of transactions over time and across businesses and countries, and have put in place automated systems for monitoring transactions with more sophisticated filters for identifying suspicious patterns of behavior. The quality of internal compliance controls in the leading firms has advanced in other areas as well, with higher level oversight of an independent compliance function with more rigorous policies to address conflicts of interest involving hedge funds and proprietary trading and the flow of confidential information across the firm.

These are examples of leading practice, and they are not at this point standard operating procedure across the range of institutions where they should be. Systematically assessing the evolving frontier of leading risk management practice is a useful way to ensure that we continue to build on the significant improvements in the overall stability and resilience of the U.S. financial system that have been achieved over the past two decades. This is important to do on a continuing basis to strengthen the shock absorbers in the financial system. It is important to do even when, or perhaps particularly when the overall economic environment looks quite favorable, as it does today.

We look forward to working with the foreign banking community to continue to identify ways in which risk management practices can be strengthened. It is in our mutual interest to insure that the practices employed broadly by the industry continue to move towards the frontier of risk management practices. Thank you.