Timothy F Geithner: Challenges in risk management

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Institute of International Bankers Luncheon, New York,18 October 2005.

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Thanks for giving me a chance to address this meeting of the Institute of International Bankers. Your presence in our markets adds greatly to the competitiveness and dynamism of the U.S. financial system. The major international institutions contribute not just depth and liquidity to our markets, but also bring new ideas and global perspectives on developments here and abroad. And the Institute has played an important role in fostering dialogue among international bankers and policymakers on issues of mutual interest.

You are meeting at a time when the financial markets reflect a substantial degree of confidence about the future—confidence in the stability of future macroeconomic outcomes and confidence in the strength of many of the world's major financial institutions. Against this backdrop, I thought it might be useful to talk about our hierarchy of concerns and priorities in the supervisory process, particularly those that relate to the financial strength of the major intermediaries and the functioning of the markets in which they operate.

I should note that we, of course, have a broader set of related supervisory responsibilities and a broader agenda of specific concerns. Just to list a few of these, we are deploying significant supervisory resources to evaluate efforts to strengthen internal controls and compliance functions, including those specifically directed at vulnerability to money laundering and fraud; we are encouraging efforts to reduce operational risk and improve resilience; and we are assessing residential and commercial real estate lending practices.

These are important, and familiar, priorities to the banks operating in our markets. Today, however, I'd like to concentrate on some of the risk management challenges that are at the heart of prudential supervision—in particular, the financial health of the core intermediaries and the major wholesale markets for finance and risk mitigation.

While these topics are always at the center of our agenda, they are worthy of special attention today for two reasons.

The first relates to the overall economic and financial context in which financial institutions operate today. We have been through a period of relatively favorable overall macroeconomic conditions in the United States, low realized credit losses, lower volatility in output growth and relatively low and stable, long-term inflation expectations. This has been accompanied by a reduction in many different types of risk premia and in expectations of future volatility. This change in market perception of future risk has occurred in the context, however, of a substantial increase in leverage in the balance sheets of the United States, the federal government and the U.S. household sector. These developments are a potential source of greater macroeconomic uncertainty.

The second reason for greater attention to prudential concerns is that we are in the midst of substantial changes in the structure of the U.S. financial system. The largest financial institutions in our markets are substantially larger than even a decade ago in the scope and complexity of their operations and in terms of their importance in the markets in which they operate. Hedge funds and other financial institutions that operate outside the scope of regulation or consolidated supervision now play a more important role in our financial markets. And we have seen a new way of financial innovation in credit risk transfer techniques and many new derivative instruments that have allowed risk to be measured and managed more effectively and distributed more broadly.

These developments have contributed to what seems to be a significant improvement in the overall stability and resilience of the US financial system, by reducing the vulnerability of individual institutions to a broader range of potential shocks. They may also, however, add to uncertainty about how well the system might function in the context of a major systemic shock. And in this sense, they create some exacting challenges for risk management.

Let me focus on three areas where this is the case: counterparty risk management with respect to hedge funds and other unregulated entities; risk management and market infrastructure issues in credit derivatives and other instruments; and stress testing and scenario analysis.

First, the greater role of hedge funds and other unregulated entities in our financial system today requires more attention by the major banks and investment banks to counterparty risk management. The greater diversity of participants in risk intermediation is probably on balance a positive thing for our financial system.

Hedge funds, private equity funds and other kinds of investment vehicles help to disperse risk and add liquidity. Their greater prominence in our markets, however, means that banks and investment banks face a heightened challenge in managing the risks involved in their exposure to these firms and in understanding the firms' ability to weather conditions of stress and their impact on market conditions in those circumstances. The degree of the systemic risk presented by the growth in the leveraged, unregulated financial institutions depends in part on how well the major dealers manage these challenges. Market practice in these areas has improved significantly since 1998, but progress has been uneven across the dealer community, and competitive pressures have caused some erosion in counterparty discipline relative to the risks in exposures.

We believe it is important that internal information systems are capable of capturing the full range of exposures to individual counterparties across the firm; that potential future credit exposure is measured realistically, including through stress tests at the counterparty level and across the firm's portfolio, and managed to prudent limits relative to capital; that credit limits and terms reflect the quality of information provided by the counterparty about its risk profile and risk management systems and are not eroded by competitive pressures; and that the risk management process tries to capture the risk to the firm that could result from the rapid unwinding of positions by leveraged counterparties.

A second challenge relates to the growth in volume and complexity of new instruments for risk transfer, which has advanced, as it typically does, ahead of improvements in the trade processing infrastructure and risk management and control practices. Although these innovations seem likely to reduce overall risk in the financial system, shortfalls in the infrastructure leave the market more vulnerable than it needs to be to adverse dynamics in conditions of stress.

These gaps are evident in the degree of manual processing required for trade capture and settlement; the substantial backlog of undocumented or unconfirmed trades; the prevalence of assignments of trades without the consent of counterparties; and in the slow adoption of market services for automated processing. Shortfalls are also evident in the limits of models and other techniques for measuring potential exposures in conditions of stress.

Some of these shortfalls are the result of limited investments in resources and technology and the limited ability of individual firms to improve market practice without a commensurate effort by other dealers. Some are a reflection of the complexity of the products and the limited experience firms have had with how these exposures trade in more adverse market conditions. Both require a greater investment of resources and attention by senior managers.

We are encouraged by the initial commitments outlined by the major dealers earlier this month to resolve a number of these problems. In cooperation with the other principal supervisors, we will be monitoring progress closely.

The third area I'd like to discuss concerns the need to improve stress testing and scenario analyses, which are among the most difficult and consequential parts of the risk management process.

What is important, as always, is to bring a forward-looking view to evaluating a firm's potential exposure across a broad range of economic and market conditions and to capture the risk in the tail of the distribution of possible outcomes.

Among the challenges we see today, even at the most sophisticated institutions, are the following:

- bringing more integration to the assessment of market and credit risk and the interactions between them,
- capturing, measuring and aggregating credit exposures stemming from activities across all of a firm's business lines,
- assessing the value of positions in portfolios of more complex and less liquid products,
- capturing the potential implications on market liquidity and price movements of the unwinding of common positions across market participants, and

- assessing the implications of the exit of a major counterparty, particularly in the more concentrated segments of the market, and the limitations imposed by the size of the institution itself in responding to adverse market conditions.

Together, the three areas I've discussed—challenges in counterparty risk management with respect to hedge funds, developments in the credit derivatives market and infrastructure and ongoing work to improve stress testing and scenario analysis–represent areas where uncertainty is necessarily high. And assessing the probability of various outcomes and the potential losses associated with those outcomes is very complicated and hard to do well. Doing so requires care, judgment and a portfolio of different approaches. This is particularly important to do well in a context when we have had such a sustained period of relatively low credit losses and low volatility.

Across all these areas, these judgments have to be translated into appropriate limits, an appropriate capital cushion above the regulatory minimum and a robust liquidity management strategy. These thresholds need to be calibrated to withstand more adverse conditions than we've seen in the recent past.

The major institutions seem in general to be managed so that they are in a stronger position to withstand the shocks of the nature and magnitude of the last few decades of experience. The apparent increase in the strength and resilience of the U.S. financial system has contributed significantly to the improvement in the overall performance of the U.S. economy of the past 20 years.

As the challenges of risk management become more demanding, it is important that supervisors and those charged with managing the major financial institutions make the investments necessary to stay abreast of the changing frontier of risk management challenges and a potentially more uncertain future.

Thank you.