

Mr McDonough comments on Capital Markets, Securities and Government Sponsored Enterprises

Statement by the President of the Federal Reserve Bank of New York, Mr William J. McDonough, before the Committee on Banking and Financial Services, U.S. House of Representatives, Washington, D.C., on 3 March 1999.

Good morning Chairmen Leach and Baker and members of the Subcommittee. When I appeared before the full Committee in October, I spoke about the near-collapse of Long-Term Capital Management and the events leading up to the private-sector recapitalization of its fund, Long-Term Capital Portfolio. At that time, I promised you that we would take a hard look at the issues growing out of that experience, particularly as they affect our responsibilities as bank supervisors. I am pleased to appear before you today to report on the lessons we have learned and the actions we have taken to reduce the possibility that such an episode could repeat itself in the future.

As I indicated last fall, three issues require particular attention by banks and their supervisors in the wake of LTCM. These are, first, the adequacy of banks' credit analysis processes; second, the effectiveness of exposure measurement; and third, the role of stress testing of counterparty exposure. In my remarks today I will detail the substantial progress that has been made, both domestically and internationally, to address each of these supervisory concerns.

But before I get into the details, let me say that I believe the LTCM episode and the supervisory response to it is fundamentally about two things: leverage and good judgment. Leverage is a fact of life in our financial world, and is a key part of the risk-taking necessary for the creation of wealth. But sometimes banks go too far in extending credit to their customers and counterparties. That's where good judgment comes in. I know - - I've been there. I was a commercial banker for 22 years before becoming President of the New York Fed, and I can tell you that the most important decisions a banker makes are how to lend and to whom. Those decisions are not easy, and often involve many shades of gray. One of our aims as supervisors should be to see that banks are using the right tools to make those judgments.

The importance of these issues extends beyond banks and their supervisors. Sound credit policies and procedures are essential not only for the stability of individual banks, but also - and more importantly - for the health of the financial system and the economy as a whole. This is because banks play a pivotal role in our economy as providers of credit. If banks make poor credit decisions with respect to a borrower, including a hedge fund like LTCM, the financial system and our economy will suffer.

Basle Report Findings

As you know, I chair the Basle Committee on Banking Supervision, comprised of bank supervisors from the G-10 countries who coordinate supervisory policy for internationally active banks. While the Committee does not have formal legal enforcement powers, its conclusions and recommendations are widely implemented, both in G-10 countries and many others. In late January, the Committee issued a report dealing with the relationship between

banks and highly-leveraged institutions, or “HLIs”. The Committee’s report provides a framework for addressing the broader issues raised by the LTCM episode, the policy responses of supervisors, and some key risk management challenges for the banking industry going forward.

In the United States, the Federal Reserve System, the New York State Banking Department, and the Office of the Comptroller of the Currency have conducted target reviews of a number of large-bank dealings with hedge funds. These reviews contributed to the Committee’s work, to the Federal Reserve System’s issuance on February 1 of new guidance to financial examiners and banks, and to similar guidance from the Comptroller of the Currency issued in January. These new standards emphasize the need for improvements in the credit risk management process at banks. The new standards will likely be complemented by a study of the implications of the LTCM episode by the President’s Working Group on Financial Markets.

Because the Basle Committee’s jurisdiction is limited to matters of banking supervision and regulation, its primary emphasis has been on ensuring that the major banks prudently manage their risk exposures to HLIs. The best way to achieve this is through the adoption of sound practices by the industry, perhaps supplemented by incentives created through capital requirements. While it is primarily the responsibility of each banking organization to manage its risks, sound practice standards give banks and supervisors a tool to measure industry progress. If banks themselves do not follow sound practices, then supervisors must step in and take the necessary action.

The Committee’s report revealed a number of deficiencies. In particular, the Committee observed an imbalance among the key elements of the credit risk management process, with too strong a reliance upon collateral. This undue emphasis, in turn, caused many banks to neglect other critical elements of effective credit risk management, including in-depth credit analyses of counterparties, effective exposure measurement and management techniques, and the use of stress testing.

Credit Approval Process

For a bank to make sound lending decisions, it needs to obtain sufficient information about the borrower. Supervisors routinely stress the need for banks to have an effective credit approval process consisting of formal policies and procedures, accompanied by documentation of actual credit decisions. When dealing with an HLI, a bank also must obtain comprehensive and timely financial information about that HLI’s risk profile and credit quality, and it must engage in an ongoing credit analysis of that HLI. In addition, a bank must have a clear understanding of an HLI’s operations and risk management capabilities. The Committee observed weaknesses in each of these areas. Let me give a few examples.

The Committee found that banks did not obtain sufficient financial information to allow for a full assessment of how much and what types of risk had been assumed by large HLIs. In particular, banks did not obtain the information needed to measure leverage. They also did not have sufficient information to understand HLIs’ concentrations in particular markets and risk categories, or their exposure to broad trading strategies.

Similarly, banks generally did not sufficiently understand the ability of HLIs to manage their risks. Because risk profiles can change from one day to the next, or even from moment to moment, it is necessary for a bank to be sure that the HLI can effectively manage its business operations and risks on an ongoing basis. In general, we did not find sufficient reviews of HLIs' risk management systems and their underlying assumptions, back office systems used to manage daily operations such as collateral and liquidity, and the major accounting and valuation policies.

Exposure Measurement

The Committee also thought that banks need to develop better measures for determining the credit exposure resulting from different types of trading activities. In particular, banks must develop more effective measures of what is called "potential future exposure." Potential future exposure measures the credit exposure between a counterparty and a bank, and how this exposure could change in the future as market prices fluctuate. As we have seen, such price movements can be substantial during periods of market stress. The ability of banks to measure potential future exposure is crucial when dealing with HLIs.

Unfortunately, methods for calculating potential future exposure had not kept pace with the growth and complexity of HLIs. Banks' potential future exposure measures have been particularly ineffective in measuring exposures not covered by collateral. For example, under highly volatile market conditions, a bank's potential future exposure can grow beyond the value of any collateral. We expect the industry to develop more effective ways to measure and limit potential future exposure, and supervisors will closely monitor progress to ensure that this occurs.

Stress Testing

The Committee's report also shows that banks must develop measures that better account for credit risk under highly volatile market conditions. This can be achieved through what we call "stress tests", where a bank conducts "what if" analyses of how credit exposures to a single counterparty could grow under extreme market conditions. These might include a large rise or fall in interest rates, a major change in an exchange rate, or a flight to quality by investors. In the case of LTCM, stress testing could have given banks at least some warning of the types of exposures they could have faced last fall. The critical importance of stress testing is noted very explicitly in our new supervisory guidance.

Sound Practice Guidance

The sound practices document accompanying the Basle report presents an important set of standards that will guide both banks and their supervisors. It appears that banks generally have tightened the credit risk management standards for their HLI exposures since the collapse of LTCM. However, it is important that supervisors try to ensure that progress continues. Memories tend to be short, and we want to make sure that as markets calm down, as they have in the past months, banks do not return to the old ways of doing business.

The adoption and rigorous enforcement of enhanced risk management practices should contribute substantially to limiting excessive risk-taking and leverage at HLIs. This is the case because HLIs cannot trade without access to financing and liquidity from banks and securities

firms. If each counterparty manages its risks appropriately, the chance of contagion to other institutions and the financial markets more broadly would be reduced substantially. It is this risk of contagion and financial market instability that is the principal concern of central banks and supervisors.

Along with other federal banking supervisors, the Federal Reserve has moved quickly to implement the recommendations of the Basle Committee's report. As I mentioned earlier, we recently issued guidance to the institutions we supervise detailing sound risk management practices for the credit risk management of trading and derivatives activities. This document identifies the areas that our examiners will review during their examination of trading activities. It is important to note that the Federal Reserve's guidance to banks and examiners covers not only HLI and hedge fund counterparties, but all other counterparty relationships. We want to ensure that banks carry forward the lessons of the LTCM experience to all potentially high-risk trading activities.

In this regard, our examiners will devote particular attention to the risks associated with rapidly growing, highly profitable and potentially high-risk activities and product lines. They will assess the adequacy of banks' reviews of counterparty creditworthiness, exposure measurement and monitoring techniques, stress testing, limit setting, and the appropriate use of collateral and other credit enhancements. Our examiners will also look at internal policies and the degree to which behavior conforms to stated policies. We have already conducted meetings with the major banks to reinforce these messages and our examiners will conduct follow-up reviews in the course of this year.

Other Possible Policy Responses

Over the past few months, there has been significant debate about other measures that could be taken to limit the potential risks to the financial system arising from the activities of large, highly leveraged, unregulated financial institutions. The Basle Committee carefully considered all the ideas that have surfaced. Our report discusses a variety of options beyond the implementation of sound practice standards. One possibility is to require higher capital charges for bank exposures to HLIs. Indeed, a primary objective of our current review of the Basle Capital Accord is to determine how to align regulatory capital charges better with the economic risks of different classes of counterparties.

We also recognize the critical need to enhance market transparency for the activities of HLIs and other major market participants. The Committee already is working to enhance accounting and disclosure practices at banking institutions worldwide. Extending these efforts to all global players that have the potential to destabilize the financial system, including HLIs, is of particular importance. An international group of central bankers is now studying various approaches to strengthening disclosure in this area.

The Committee also considered the advantages and disadvantages of imposing direct regulation on the HLI industry. There are a number of critical obstacles that would have to be overcome before a direct regulatory approach could be implemented. To be effective, any regulation would have to extend to jurisdictions around the world where HLIs are chartered, some of which have more highly developed and more stringent supervisory structures than others. This would require a high level of coordination involving the political, legislative, and judicial bodies of many countries. There is also the difficulty of establishing a regulatory

regime for HLIs that is not easily circumvented. For these reasons, I believe the most practical approach is to focus on financial institutions' lending activities, because such an approach offers a near-term and cost-effective remedy to the systemic risks posed by HLIs.

Challenges for the Banking Industry

I strongly believe that both the official and private sectors have important roles to play in addressing the challenges arising from an increasingly complex and dynamic financial services industry. First and foremost, we hold banks accountable for ensuring that sound credit risk management standards are upheld and that these keep pace with financial market innovation. If competitive pressures lead to bad practices in one bank or the industry as a whole, our job as supervisors is to raise standards and ensure that sound practices are restored.

In my remarks today, I highlighted a number of areas where progress has been made. Of course, there is more work to be done by banks and supervisors. High on the agenda should be the development of more meaningful measurement of risk exposure and

the implementation of effective stress-testing techniques. Another important area that requires further industry attention is the measurement of leverage. Finally, I believe that the industry should devote more thought to the appropriate valuation of positions during periods of market stress and illiquidity – which is particularly relevant to the use of collateral to protect against credit risk.

These are just some of the broader issues arising from the LTCM experience and the market turbulence last fall. But I believe that we are meeting the challenge and have made quick and significant short-term progress.

I look forward to your questions.