For Release on Delivery
3:30 pm. EST
December 2, 1994

Remarks by

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at the

Conference on Banking, Financial Markets

and Systematic Risk

sponsored by

The Office of the Comptroller of the Currency

Washington, D.C.

December 2, 1994

Introduction

I am delighted to participate in this conference and discuss the challenges we face in addressing systemic risk.

There are numerous definitions of systemic risk, but as a central banker I am uncomfortable with most of them. Especially within the financial community, the term 'systemic risk' seems to have become synonymous with any large-scale disruption to the efficient or normal functioning of financial markets. Moreover, the notion of efficiency is in the eyes of the beholder. Such definitions seem to miss the obvious evidence that the U.S. -- and perhaps the global -- financial system has been extremely resilient when shocked. Large losses for some or re-evaluation of positions by others do not necessarily mean systemic risk.

It seems to me that the salient characteristic of systemic risk is the potential to affect real macroeconomic activity. Certainly, the initial impetus might be a cascading of failures originating from a single financial shock. Or, it may be associated with a generalized loss of confidence in a class of financial institutions. In either situation, holders of financial assets may become extremely risk averse -- they hold back and liquidity in financial and credit markets could be impaired. What is certain is that the causal factors of such incidents are unpredictable in advance and that a given shock can have different effects depending on the economic environment.

Developments Increasing the Potential for Systemic Disruptions

Over the past 10 or 15 years, a number of economic developments have had important implications for systemic risk. Perhaps the most profound development has been the increased speed and force by which disturbances can be transmitted among financial markets, both domestically and internationally. In part, this development reflects improvements in technology that permit the instantaneous dissemination of information. A second factor is the globalization of financial markets. In addition to technological advances, this reflects the expansion of international trade, the deregulation of financial markets, and the growing importance of institutional investors seeking the potential benefits of international diversification. Globalization has led to a virtual explosion in the volume of foreign exchange and cross-border securities transactions. Both involve significant settlement risk. Increasingly, such transactions are being funneled through a relatively small set of intermediaries that provide custody and settlement services. Globalization also makes it increasingly likely that the resolution of a significant financial disruption will require close co-ordination and co-operation among public and private sector authorities in multiple countries. I don't believe that this element of systemic risk or its resolution have received sufficient attention.

Another related development is the exponential growth of derivatives markets. The ability to hedge foreign exchange, interest rate, and other market risks more easily has been a further impetus to the integration and globalization of financial markets. But

while derivatives have worked to improve overall market efficiency, their growth also carries potential implications for systemic risk. Because market-makers typically hedge their derivatives positions on spot and forward markets and on futures exchanges, they are heavily dependent on their own access to credit and on the liquidity of the markets. This dependence was illustrated during the 1987 stock market crash.

Derivative market-making tends to be highly concentrated in relatively few large firms having a global reach. These dealers need sufficient capital to take large positions. They also need the technical expertise as well as the information processing and communications systems to manage credit, settlement, market, and liquidity risks globally. In the unlikely event that such an institution should fail, finding a liquidator to manage these complex risks would be a challenge.

The rapid growth in off-balance sheet activities also raises questions about transparency. Because accounting and disclosure standards for off-balance sheet activities have failed to keep pace with recent market developments, there are questions about the ability of traders and investors to evaluate the riskiness of potential counterparties having sizable derivatives positions. Indeed, the lack of transparency is, I think, one reason that market makers in the derivative markets have been subject to such wild rumors this year. Until there is better public disclosure of relevant information, the public may overreact in a time of market stress.

Addressing Systemic Risk

In this changing environment, our traditional public policy instruments for containing financial disruptions may have become less effective. Open market operations and discount window lending, while still critical tools for providing central bank liquidity and bolstering public confidence, may not be well-suited to addressing fundamental credit quality concerns. Moreover, the adequacy of the backstop provided by the federal deposit insurance system may be less certain for several reasons: (1) the greater importance of non-banks in the financial system, and (2) recent statutes that give depositors preference over other creditors and that restrict the FDIC's ability to protect uninsured creditors at failed depositories.

Because of concerns about financial market globalization and systemic risk, there is a renewed focus in the United States and abroad on improving the resiliency of the financial system so that both the probability and likely severity of financial shocks are reduced. But public authorities have been extremely reluctant to broaden the government safety net, reflecting the obvious moral hazard concerns. To the extent financial risks are borne by the public sector, practitioners themselves have little incentive to develop and implement effective risk management systems. Yet, ultimately, private agents are in the best position to monitor, limit, and manage their own risk exposures. For these reasons, public policy efforts have focused on three areas: (1) improving risk management practices used by institutions; (2) improving the infrastructure of payments and

settlement systems; and (3) improving financial disclosure and accounting practices, especially for off-balance sheet activities. To the extent we are successful in these efforts, we may be able to do as much to reduce systemic risk in the 1990s as deposit insurance did in the 1930s.

Improving Risk Management

Despite the growing importance of nonbank firms in the financial system, banks retain a central role. As bank supervisors, we have a fundamental obligation to ensure that banking organizations are not a source of systemic risk. We have taken numerous important actions toward this end over the past several years. First, under the auspices of the Basle Committee on Banking Supervision and the G-10 Central Bank Governors, great strides have been made in enhancing the consolidated supervision of internationally active banking organizations and ensuring that, on a uniform basis, banks are adequately capitalized for the risks they assume. Risk-based capital requirements for credit risk are already in place, and there are ongoing efforts to incorporate market risk as well. In addition, to reduce credit risks associated with derivatives activities, the Basle Accord has been amended to provide incentives for banks to utilize legally enforceable bilateral netting agreements.

Within the United States, the supervisory process has been strengthened, among other things, to encourage greater discipline in the banking industry. On-site examinations

play a critical role in the supervision of banks, and an increasingly important element of our examinations is an assessment of the adequacy of internal risk management systems. Internationally, a similar approach has been adopted by the Basle Supervisors Committee and the International Organization of Securities Commissions. Both have issued coordinated documents stating similar principles for promoting sound internal risk management for banks and securities firms. In recent years, the U.S. banking agencies have taken steps to strengthen the training and capabilities of examiners in the risk-management area, particularly with regard to derivatives.

Various provisions of the 1991 FDIC Improvement Act (FDICIA) reinforce these supervisory initiatives. Annual full-scope, on-site examinations of major banks are now required. Risk-based deposit insurance premiums and prompt corrective action policies have encouraged banks to increase their regulatory capital levels.

U.S. and foreign authorities have also worked to enhance both their own and practitioners' understanding of risk management issues. The results of these supervisory, regulatory, and educational initiatives are quite evident. Within the last few years, we have observed substantial payoffs in terms of increased use of bilateral netting, marginning arrangements, marking positions to market, and collateral agreements among counterparties. In addition, we have observed generally improved management of market risks at bank and nonbank institutions alike. I expect these trends to continue.

Improving Infrastructure

United States and foreign authorities also have been working to reduce the magnitude of settlement risks. One effort has sought to reduce legal uncertainties regarding the enforceability of bilateral netting agreements, including so-called close-out agreements. Such agreements have the potential to lower settlement risk dramatically by reducing both the number and amount of payments that must be made compared to settlement on a gross, transaction-by-transaction basis. Within the United States, an important provision of FDICIA now ensures the validity and enforceability of bilateral netting arrangements among financial institutions. Work is also proceeding along similar lines in several other countries. This process has been hastened by the amendment to the Basle Accord, mentioned earlier, which permits banks to recognize the benefits of netting for capital purposes only if they can demonstrate the enforceability of their netting agreements in all relevant jurisdictions.

On a second track, we are striving to reduce the duration of settlement risk through improvements to payment and settlement systems. Within the United States, for example, settlement risk associated with CHIPS payments has been reduced by the implementation of 'same-day' settlement, limitations on bilateral and multilateral settlement exposures, as well as collateral and enhanced loss sharing arrangements. In addition, to lower operational barriers to reducing Herstatt risk, the Federal Reserve recently announced that it will expand the operating hours of Fedwire from the current 10 hours to 18 hours,

beginning in 1997. Steps also are being taken by other central banks to develop or improve their real-time payments systems.

Transparency

To manage counterparty risks effectively, market participants need timely and accurate information about the financial conditions of potential counterparties. Similarly, in order to respond effectively to potential financial disruptions, supervisors and central banks need such information. One unfortunate consequence of the rapid pace of financial innovation in recent years is that financial accounting and disclosure practices have not kept pace, especially in the area of off-balance sheet activities. The lack of market transparency is of concern to policymakers and practitioners around the world.

From a regulatory standpoint, efforts are under way to improve the available information on banks' off-balance sheet exposures. In 1994, Call Reports filed by U.S. banks collected new information on derivatives held for trading purposes and on nonperforming derivatives contracts, to supplement information already required on notional amounts and replacement costs. In addition, beginning in March 1995, Call Reports will require additional data on derivatives positions and associated risks, including detailed disclosures of fair values, net credit exposures, and breakdowns of trading revenues. The FASB has adopted a similar standard, FAS 119, for firms filing GAAP financial statements.

However, these are only first steps toward improving the reporting of off-balance sheet instruments. Much more is needed, particularly in the area of quantitative disclosures about an individual firm's risk management objectives and policies and whether their policies actually achieve the objectives. A framework for such disclosures was recently laid out in a discussion paper prepared by a working group of the G-10 central banks chaired by Peter Fisher of the Federal Reserve Bank of New York.

Conclusions

In closing, I would note that large-scale financial crises have not occurred in the United States since the 1930s. There actually have been numerous major shocks that could have been destabilizing -- such as interest rate and exchange rates fluctuating more widely, the 1987 stock market crash, the recent problems of S&Ls and banks, and the failure of a major securities firm. Through all, the financial system has shown remarkable resiliency.

This has not been happenstance, but reflects, I believe, private and public sector efforts to strengthen the financial system. Clearly, the advent of deposit insurance and improvements to date in the financial infrastructure have been significant developments. Equally important have been improvements in risk management systems at the level of individual firms. Over time, as real and financial risks in the economy have evolved, so too has the sophistication of the systems used by major financial institutions to limit

and manage risk exposures. Ultimately, these risk management systems have been, and will continue to be, the front line of defense against systemic disruptions.

An additional factor contributing to the resiliency of our financial system has been the effectiveness of public institutions responsible for dealing with systemic risks. In addition to insisting that the infrastructure be improved and that banks adopt effective risk management techniques, liquidity has been provided to the system when needed. When potentially destabilizing shocks have occurred, they have been successfully contained, at least partially because of regulators' understanding of the systemic risks involved and their knowledge of financial markets and relevant market participants.

Looking ahead, as we strive to further strengthen the global financial system, we will need continued work and cooperation among public and private sectors internationally. With this commitment, I think the outlook is good for the development of markets and risk management capabilities that limit systemic risks while supporting a dynamic and growing world economy.