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"The Challenges Of Risk Management In Today's Environment"

First of all, let me thank you for the invitation to speak today. I appreciate the work you do on behalf of our economy every day and it is an honor to be here.

In thinking about this speech, and what I would talk to you about today, I spent some time thinking about how the business of risk management in financial institutions has changed since I began in the banking business more than 30 years ago. Back then, the world was a simpler place. The economy was more regulated. The financial markets were less volatile. The universe of known risks was fairly small - and the techniques for managing those risks - even in the larger institutions - were fairly simple ones. You knew your customers, you kept your nose clean, and you tried not to get upside down in any one area of your business.

As we all know, the world is a much different place now. The banking business is much different. And the jobs that you do are very different - to a degree your predecessors, sitting in your chairs thirty years ago, could not even imagine. I would like to take a few minutes today and discuss how both the opportunities and the challenges of financial risk management have grown over the years, and what that might mean for you as risk managers in the years ahead.

It is perhaps obvious in hindsight, but worth reflecting on, that the macroeconomic environment became less predictable and more volatile in the 1960s and 70s, and has largely remained so since then. What we didn’t fully realize then, but can appreciate better now, is that we were embarking on two great revolutions that would change the global financial landscape forever. The first revolution was great technological change. The second was tremendous global integration. These trends would force an era of significant deregulation in banking, finance, and other important industries.

In many respects, these revolutions made the world smaller terms of financial transactions. The money many of you use to fund your lending today may come from around the block, from faraway financial centers, or indeed from around the world. You are partners in syndications and securitization transactions with literally hundreds or thousands of different parties - each of whom brings to the table a different appetite for risk and a different set of interests.

There have been previous eras of globalization, of course, but these tended to take place within fairly stable, regulated regimes based on the advancement of empires or rigid economic rules of the road - like the gold standard of the last two centuries. During the last 30 or so years, however, globalization has been largely driven by market forces, and the market has been relied upon in an unprecedented way to determine prices and trade flows. This less-regulated world can also be an unstable world.

By the early 1970s, growing dependence on international trade and finance spelled the end of fixed exchange rates for the major economies. Inflation rates rose with commodity prices. We learned a hard lesson. We learned that macroeconomic policies had to become much more linked to developments in the financial markets - and that not heeding this lesson could lead to imbalances and economic instability.

The costs of maintaining stable, regulated industries became much higher when industries like banking became subject to high and volatile interest rates. As the 1970s progressed we saw tangible evidence of increased financial volatility, starting with exchange rates and moving to commodity prices, inflation, and interest rates.

If you want to see how the world has changed, just look at a couple of the financial sector's terms of art. In the 1960s and 70s, there was much focus on "forecasting" as a tool for economic policy and financial management. At the end of the 1970s, after financial volatility had increased and fine tuning of the economy fell into disrepute, economists effectively concluded that "forecasting is dead." In its place, in the 1980s and beyond, is "risk management". A new buzzword for a new era, to be sure. But also reflective of a shift that had occurred in your work - we had gone from a world of predictable outcomes to a world of risks that had to be managed. Nowadays, the goal is not to forecast the future but to understand a wide array of possible scenarios - and be ready.

None of this is inherently bad. As I mentioned at the outset, this new era presents challenges - and it presents opportunities as well. Deregulation, for example, was one result of these changes. In banking, we've seen dismantling of usury ceilings, Regulation Q deposit rate ceilings, branching restrictions, and the walls between banking and commerce.

To deal with this new world, the financial markets created new products to help cope with the volatility. These new tools included many of the workaday staples of the risk management trade: futures, options, forward contracts, swaps, caps, collars, derivative contracts. Many of these tools weren't even new; some have been around in various forms for centuries. But they found new uses in restoring some stability and predictability to an inherently volatile and unpredictable world economy.

But this revolution in risk management could not succeed without making sure we created product standards, legal structures, markets and exchanges, reporting practices - in short, a regulatory framework to ensure they were up to the task of dealing with modern volatility and ensuring a level playing field for all the market participants.

With these powerful new financial tools -- and the systems and models to back them - your organizations could focus on meeting the challenges and mastering the opportunities before you.

Let’s look at the opportunities first. The old, slower, more highly regulated financial world - by its very nature - limited your potential. It confined your market to local or regional customers and limited your product offerings to things you always did and that your regulators would let you engage in. You may have tended to bread-and-butter lending or activities that appeared to be a sure thing. If you were a home lender, and interest rates rose above the federally-imposed deposit rate ceilings, you stopped making home loans until interest rates fell again. That was the original meaning of the term "credit crunch" - and this had repercussions far beyond the financial sector.

Today, of course, it’s different. Lenders can intelligently do business with all kinds of borrowers across the entire business cycle - a factor that has proved helpful to us in the recent economic downturn. Historical databases allow you to estimate the probability of default, the loss given default, and correlations across borrowers. In turn, you are better able to price risk, hedge risk, and manage risk. This increases not only the range of products on offer at your institution, but also the potential pool of borrowers - again with economic consequences far beyond the financial sector.

These new risk management capabilities also lead you into new, non-lending lines of business where your tools of quantification can detect profit opportunities and evaluate exposures. Securities underwriting, venture capital financing, brokerage and other activities permit you to follow your customer to new financial products that better suit their needs. From the FDIC’s perspective, this is a great benefit. This diversity of income streams, in fact, are one reason financial institutions are doing so well in this economic downturn, when commercial lending has not been doing well.

Finally, these same techniques that help you manage your exposure also help you with your internal management. You can measure and optimize diversification that occurs across product lines, and allocate capital efficiently to each exposure according to its inherent risk.

We almost take this for granted today. Yet it was scarcely more than a decade ago that banks encounter profound problems in efficiently allocating capital. The methods banks and thrifts were using at that time to allocate credit and manage risks did not hold up well in the new, faster, more volatile environment.

The result was the worst banking crisis since the Great Depression. The ordinary American didn’t notice it a whole lot because the FDIC did a great job of preventing a major economic disruption. Yet the crisis did force banks to update their risk management practices to reflect the new financial environment - and I would submit that bank performance in this most recent downturn indicates they were well-served by this effort.

When banks efficiently allocate credit in the economy, it helps all of us - not just the financial sector. Large firms, for example, have several options for raising capital, from bank loans, to commercial paper, to bond issuance - and even much of the nonbanking activities are nonetheless underwritten by banks. As far as small companies go, the National Federation of Independent Business reports its members have had no problem obtaining credit on favorable terms throughout the economic downturn - and most of this credit comes from banks. Individuals, too, enjoy unprecedented access to credit. Home ownership is at an all-time high of almost 68 percent of U.S. households. Millions have access to credit cards, auto loans and installment loans, even if they have limited or imperfect credit histories. While I have some concerns about our continuing high level of consumer indebtedness, it remains true that America's consumers have helped us maintain much-needed forward momentum in the economy over the last couple of years. This would not have happened without their ability to access credit through their financial institutions.

But more impressive still has been banks' ability to efficiently allocate risk in the economy - another matter we watch very closely at the FDIC. They now routinely use interest-rate swaps and other derivative instruments, for example, to manage their risk. Loan syndications and securitizations have helped cut risk into smaller pieces that can be held at lower cost by a large variety of investors.

But before we get carried away with listing the benefits, let's take a sober look at the serious challenges that also accompany our new financial world.

Many of them have to do with managerial challenges presented by complexity and technology. Complex financial instruments are powerful tools. They require thorough, well documented, well-grounded analytical approaches to understand the instrument and how its value may vary across alternative future scenarios. The mathematics is complex. The computer programming is complex. The terms and the structures of the instruments themselves are complex. The legal structures and regulations governing them are complex. How they interact under alternative assumptions is complex. I know this firsthand because the FDIC, just this year, had to manage a complex securitization portfolio we inherited from a failing bank.

Our portfolio was relatively simple: subprime credit cards. The range of instruments underwritten by your institutions every day presents even more complexity. The volume of analysis in many banks is much more than can be handled by one person, or even one department. How does the Chief Executive Officer of a financial institution, or the CFO or the Chief Risk Officer, ensure that all of the risk analysis that takes place within the enterprise is well-coordinated? Who can sit in one place and truly comprehend the risk in a complex institution - and ensure that the various pieces add up to a whole? Yet, this is your challenge every day.

To help us with this complexity, we rely on computers. We could not function without them, but with them come a number of operational concerns, not the least of which is cyber-security. The war on terrorism underscores the fact that there are any number of groups with malicious intent and sophisticated technology who cannot be counted on to play by the rules. These groups see U.S. financial institutions either as an opportunity to perpetrate fraud or attack a key component of our nation's critical infrastructure.

We also deal with complexity by farming out our due-diligence activities. We are increasingly reliant on ratings agencies and other third party analysts to provide input into credit decisions. The concern here is not so much whether the third party analyst is well-qualified; they typically represent the state of the art. The question is whether their accountability is the same as yours. The accounting and corporate governance scandals we have witnessed this year have underscored the problems associated with getting financial interests properly aligned, both within the firm and with outside parties. These problems are especially acute when it comes to outsourcing risk management activities.

As banks diversify their financial activities, the range of risks you must grapple with also grows. You have to worry now about the risk of class-action lawsuits, the reputational risk that comes from high-profile investigations due to the behavior of your borrowers. All of these could pose a threat to your bottom-line and you are forced to plan accordingly.

This past July, the FDIC held a symposium in New York on the question of risk management in large, complex financial institutions. And earlier this month we held another symposium, inviting top academic experts to come in and advise us on the application of credit risk modeling techniques to price deposit insurance and manage our insurance risks. The main lesson we've drawn from these sessions is a simple one and - indeed - one that could apply to any bank represented in this room: be careful how much you rely on models or others to tell you what your risk is. And there is no substitute for a good culture of credit in your organization. These are universal values in your industry. While these values can be enhanced by the more complex instruments available to us, we should not use these instruments as a substitute our common sense, or sound judgement. That is your challenge as risk managers and ours as a financial regulator.

Before I close, let me take a few moments and review how we're doing during this economic downturn. The banking industry has fared well through the recession that began in March 2001. Despite the problems in the broader economy, commercial bank earnings have actually risen - to a record $23.4 billion in the second quarter of this year. This strong performance has taken place in an environment of falling interest rates and a steep yield curve. Net interest income for commercial banks in the second quarter was some $5.6 billion higher than a year ago. These results tend to obscure the fact that second quarter loan-loss provisions rose by $2.0 billion, or 23 percent, from levels a year ago.

The steady deterioration in bank loan performance that we've seen during the last couple of years has been directly tied to the well-publicized troubles of the U.S. nonfinancial corporate sector. A number of large banks -- banks with assets greater than $1 billion -- have seen deteriorating commercial credit quality conditions, mainly as a result of a growing volume of poorly performing syndicated loan exposures.

Results from annual interagency Shared National Credit reviews in recent years have provided direct evidence of this deterioration. Last year's Shared National Credit review covered $ 2.1 trillion in corporate loan exposures. Criticized credits -- that is, those credits assigned a Special Mention, Substandard, Doubtful, or Loss classification - totaled 9.4 percent of total commitments in 2001, up from an all time low of 2.5 percent in the 1998 review.

We just completed our review for this year, which covered nearly $2 trillion in corporate loan exposures. The final results of the review won't be ready for public release until next month. But, I can tell you, that we expect this review will show a continued deteriorating trend.

Here's why. First, nonperforming asset levels continued to grow at some larger banks. Second, we believe recent record levels of corporate bankruptcy filings may not have fully run their course. Third, we see continued weakness in several highly leveraged industries, such as the telecommunications sector.

In the second quarter, noncurrent commercial loans for large banks reached 3.1 percent of outstandings -- the highest level since the third quarter 1993. While noncurrent and loss rates for commercial loans at small banks stabilized in the first half of 2002, large banks continue to experience higher noncurrent and loss rates among commercial loans, primarily as a result of credit deterioration in syndicated loans.

A number of factors are impeding improvement in commercial credit quality at some of the larger banks. Corporate profitability has yet to recover fully, and many firms continue to operate with significant financial leverage. Lower investor tolerance for risk has created a far less hospitable financing market for speculative-grade firms, which may further strain liquidity and increase the likelihood that these companies could default as debts mature.

The number of bankruptcies filed by public companies this year could challenge the record set in 2001. Bankruptcydata.com reports that 257 publicly traded companies filed for bankruptcy in 2001, while 134 companies had filed by August 26, 2002. In the first half of 2002, Moody's downgraded roughly 4.4 companies for every company upgraded. The main reasons for rating downgrades have been poor profitability and high leverage.

At the same time, we do see a number of indicators that suggest commercial credit quality problems at large banks could be approaching a peak. While Moody's reports that the 12-month issuer default rate on U.S. speculative-grade corporate bonds remained high, at 10 percent, in July 2002, this represents a decline from what appears to have been the cyclical peak of 11.5 percent in January. Also, the ratio of ratings downgrades to upgrades of 3-to-1 in July was well below the 5-to-1 ratio for the second quarter.

Changes in underwriting standards also bode well for credit quality at commercial banks. A number of surveys show that lenders have tightened underwriting standards in recent years. Large banks began reducing commercial loan exposures in the second quarter of 2001 due to tighter lending standards as well as reduced demand for commercial loans on the part of borrowers who were reducing investment expenditures and, in many cases, substituting bond issuance for bank loans.

Improving economic conditions also suggest that commercial credit quality should also improve - albeit with a lag. A range of economic indicators suggest that a recovery could be under way, but it is a slower recovery than many had expected earlier this year. The housing sector remains robust. Job conditions have stabilized. Real gross domestic product -- GDP-- grew by 5.0 percent in the first quarter 2002 before falling off to 1.1 percent in the second quarter. Economists surveys by the Blue Chip Economic Indicators maintain that the recovery is intact and forecast that the economy will grow by 3.2 percent next year.

Another ongoing concern affecting commercial credit quality is corporate profitability. Corporate profits have remained depressed since first quarter of 2001. Year-over-year earnings growth for the S&P 500 earnings is estimated to be 1.4 percent for the second quarter, which would mark the first quarter of positive growth since late 2000.. However, profit estimates are now being revised downward for the second half of 2002, reducing expectations for a sharp rebound in corporate earnings before the end of the year.

I'll finish by repeating that we continue to see deterioration in commercial credit quality at present. We are looking for signs, however, that it may be ready to turn around. We believe an improvement in syndication credit quality is dependent on two main conditions. First, corporate earnings must rebound for a sustained period of time. Second, the capital markets that provide refinancing opportunities must stabilize to produce a definitive bottom in the credit cycle. Otherwise, companies with depressed earnings or highly leveraged positions will become vulnerable to maturing debts and refunding risk implications. Firms seeking to roll over maturing debt clearly face a less hospitable financing market today with lenders demanding higher spreads.

Despite the challenges, we are beginning to see real progress in the corporate sector and in the broader economy. If this trend continues, we will have seen the peak of corporate credit problems in 2002. We will continue to monitor these trends and let you know what we're seeing. I encourage you to pick up the phone and call us if you think our research folks or analysts can be of use to you in managing your risk.

Again, I appreciate the opportunity to speak here today.

Thank you.

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