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Supervisory Challenges Related To New Financial Products

Remarks by

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I. Introduction

It is a pleasure to be here and participate in your discussions of current business, and policy issues facing the banking industry. In particular, I'm especially happy to have the opportunity to address the supervisory challenges posed by new financial products.

As you know, technological and financial innovation is spawning new and increasingly complex ways for banks and other institutions both to take and to manage risk. Moreover, securities, derivative contracts, loans and other financial instruments are becoming increasingly interchangeable and harder to differentiate using traditional benchmarks. In this environment, supervisors face an important challenge in adapting their existing supervisory regimes to recognize and take advantage of advances in risk measurement and management. This challenge applies to supervisors of all types of financial institutions, not just bank supervisors. Indeed, the blurring of products, business lines and other traditional institutional distinctions is placing increasing pressure on all financial regulators to achieve some form of harmonization or convergence in supervisory regimes. Failure to do so can lead to regulatory arbitrage and its associated market inefficiencies.

Today I would like to discuss areas where supervisors are making significant progress to meet these challenges. I also hope to identify areas where there is still work to be done.

II. Role of Supervisors

Supervisors of financial institutions share the common objective of ensuring that the institutions they supervise are not a source of systemic risk. Additional supervisory objectives vary depending on particular statutory and regulatory mandates. For example, U.S. bank and thrift regulators have the important objective of protecting the safety net. Bank supervisory programs are built around that objective.

In general, all financial institution supervisors pursue their objectives by ensuring that the institutions they supervise: 1) practice sound risk management; 2) have adequate capital, and, 3) conduct their activities in a reasonably transparent manner. While different supervisors may place different emphasis on each of these basic elements, they, nonetheless, represent a basis upon which to seek possible harmonization of supervisory regimes. Over the past several years both industry groups and supervisors have been aggressively addressing each of these elements as they relate to new products and risk management techniques. These efforts were first in the context of derivative instruments but more recently have been applied to all types of instruments and portfolios. It is useful to review this progress.

III. Sound Risk Management Practices

First, with respect to sound risk management practices, the 1993 Group of Thirty study on derivatives was indeed a watershed. Supervisors followed suit -- U.S. banking agencies each issued their own guidance on sound risk management practices. Last year an international communique on sound practices for derivatives was issued jointly by the Basle

Committee on Bank Supervision and the International Organization of Securities Commissions (IOSCO). This joint issuance is notable because it demonstrates the enhanced international coordination of the supervisors of banks and securities firms.

All of the various sound practice statements released thus far, ranging from the G-30 study to the BIS/IOSCO releases, emphasize the same risk management fundamentals. They point to the importance of: 1) active oversight by an institution's board of directors and senior management; 2) clear policies, procedures, and lines of authority; 3) independent risk management units; 4) comprehensive risk measurement and reporting systems; and finally, 5) other comprehensive internal controls and audit procedures. It is important to note that these fundamentals are basic sound practices that well-run institutions have applied to traditional banking and securities activities for years. To a large extent, therefore, the current focus on risk management represents an application of tried and true fundamentals to new activities and financial instruments, but using new risk measurement capabilities.

The Barings, Orange County, and now Daiwa Bank incidents are providing valuable lessons of the importance of applying even the most basic of these fundamentals to new products and activities. Too often, the focus of both management and supervisors has been on the "high-tech" aspects of risk management--the modeling and measurement aspects of complex instruments or their interrelationships. However, while this is, undoubtedly, an important element of risk management in this time of rapid product innovation, the post-mortums conducted to date on Barings and Orange County clearly point the finger at fundamental breakdowns in several relatively simple, "low-tech" elements of risk management. Common sense internal controls involving senior level oversight, segmentation of duties, and independent risk assessment appear to have been violated in both cases. While supervisors face the challenges of incorporating new risk management techniques into their supervisory regimes -- including high-tech elements -- it appears that the industry still faces significant challenges in applying the "basics" to their new products and activities. One positive aspect of these unfortunate events is that they have served as vivid wake-up calls to the industry and end user community.

Supervisors in different countries and of different industries use various channels to ensure that the institutions they supervise follow sound risk management practices. U.S. banking supervisors rely heavily on the annual full-scope examination. A number of foreign banking supervisors depend on outside auditors to evaluate the adequacy of controls. Securities and commodities regulators place significant oversight responsibilities with self-regulatory organizations and external auditors.

All of these players have looked to the various supervisory pronouncements on sound practices as guides in structuring and evaluating the adequacy of risk management as applied to new products and activities. Along these lines, one such initiative is the Federal Reserve's Trading Activities Examination Manual published in 1994. It identifies specific polices and procedures for assessing the risk management of trading operations for both cash and derivative instruments and has been well-received by bank and non-bank supervisors. Management and auditors of many banks and securities firms, as well as consultants, have also found this document useful in defining the steps they use to evaluate the adequacy of risk management techniques.

IV. Capital Adequacy

Supervisors are also currently assessing their approaches to capital adequacy in light of recent technological and financial innovations. The increasing volume and complexity of financial transactions and the rapid advances in risk management techniques are making it increasingly difficult to address prudential adequacy concerns using traditional standardized, "rule-of-thumb" capital regimes. Accordingly, a common thread in many recent capital adequacy initiatives is the use of an institution's own internal model to measure the risks against which regulatory capital would be required.

Basle Market Risk Proposal - The most notable of these efforts is the Basle market risk proposal. In April, the Basle Committee recommended a two-pronged approach for determining minimum capital requirements for the trading activities of internationally active banks. Such banks would be permitted to use either: 1) a "standardized" risk measure that applies uniform measurement procedures and assumptions for all banks; or 2) their own internal value-at-risk (VAR) models, subject to specified constraints and "qualitative" standards of risk management. Use of internal models would also have to be supplemented with a rigorous program of model validation and stress testing.

The Federal Reserve has been the principal advocate internationally of using internal models. We believe this route provides incentives to promote sound risk management while minimizing supervisory intrusion that might impede innovation in financial risk measurement.

However, using daily VAR models alone to determine a capital charge may not be sufficient. While useful as a day-to-day management tool, daily VAR calculations do not incorporate the stress tests which would assess capital adequacy under a variety of economic and market conditions. Indeed, most large institutions do not, themselves, rely solely on their daily VAR estimates for allocating capital or evaluating its adequacy. While supervisors want to build on internal models, ultimately adjustments may be required to produce a credible, consistent, and meaningful capital charge for market risk. At present, the Basle proposal involves constraints on certain model parameters in order to produce sufficient comparability among models of different banks and to obtain a sufficiently conservative measure of risk. Changes to these constraints are being considered as a result of the public comment process.

E.U.'s Capital Adequacy Directive - A driving influence on the convergence in the capital rules of banks and securities firms is the existence of large universal banks in Europe. This harmonization is underway by means of the implementation of the European Union's Capital Adequacy Directive or CAD. Due to be implemented in 1996, the CAD poses a capital calculation system similar to the standard approach proposed by Basle. A limited internal model option is also available in the CAD, but the standard approach is also more consistent with capital structures used by securities broker-dealers or investment bankers. Nevertheless, it is expected that, ultimately, the CAD will be "adjusted" to conform with the Basle proposal when that initiative is finalized.

SEC Capital Rules - The use of internal models in determining U.S. securities firms' capital requirements is on a somewhat slower track. Currently, the SEC is reviewing its capital rules with an eye toward establishing a unified "hair-cut" methodology for fixed income products that, while not implementing an internal model measurement system, would recognize the risk reducing properties of some hedge positions. Cognizant of other supervisors' efforts regarding internal models, SEC staff is monitoring securities firms' internal model calculations.

Proposals to use internal models for measuring capital adequacy have also surfaced with regard to the unregulated derivative product subsidiaries of securities firms. In its recent report, the securities industry's Derivatives Products Group (DPG) recommends the use of institutions' own VAR calculations to assess capital adequacy. The Group endorses the use of some of the same modeling parameters identified in the Basle proposal. Similarly, it also identifies the need for supplemental stress testing and a regime of model validation. The recommendation, along with other initiatives, suggests that internal model approaches to capital adequacy may offer an avenue to capital harmonization between U.S. bank and security regulators.

Pre-commitment approach - While the immediate focus of bank supervisors has been on the use of internal models in the context of the Basle proposals, let me point out that the Board has issued a concept paper on a possible future approach to capital adequacy that could be viewed, in my judgement, as "the ultimate internal model approach". This so-called "pre-commitment" approach would require a bank to specify the amount of capital allocated to support market risks. The bank would be expected to manage its trading portfolio to limit cumulative trading losses over some interval to the capital allocated. This capital commitment would be publicly disclosed. To assure that adequate capital is committed for the risks involved, the regulator would assess penalties on institutions failing to limit losses to their capital commitment. The assessment of any penalties would also be publicly disclosed.

This proposal is an intriguing concept, ripe for discussion and additional research. The specification of the penalty function is problematic since it would need to be sufficiently strong, certain, and public, to have a credible impact. Yet its imposition could come at the worst possible time for a bank and could have safety and soundness implications. The element of public disclosure of capital commitments, VAR estimates, and trading results, and the incentives that such disclosure would entail, are particularly interesting. The competitive issues involved in such disclosures clearly must be assessed and there are undoubtedly other issues to be considered. I urge all of you to give this concept serious thought and comment accordingly.

V. Disclosure, Regulatory Reporting and Accounting Initiatives

Just as with sound practices and capital adequacy, there are a number of initiatives underway to advance the transparency of new products and activities in an institution's risk profile. In both 1994 and 1995, U.S. bank supervisors dramatically increased the amount of information collected on derivatives activities in bank Call reports. The voluntary framework advanced by the DPG recommended similar enhancements to the reporting of securities firms' derivatives activities to supervisors.

Internationally, in May, the Basle Committee on Banking Supervision and IOSCO's Technical Committee issued a joint document advancing a "framework" to guide banking and securities regulators in determining the kinds of information that could assist in the supervision of institutions' derivatives activities. An important part of that framework identifies minimum information needed to assess the effects of derivatives on an institution's risk profile. Both international bank and securities firm supervisors are actively pursuing implementation of the common minimum framework advanced in that joint paper. The two Committees plan to update the joint supervisory information framework periodically. All in all, this framework should help promote more consistent methods of supervisory evaluation of banks' and securities firms' exposures arising from new products and activities, including derivatives.

Other international initiatives are also underway with regard to disclosure. In 1994, the BIS published the Fisher Report which calls for firms to disclose more quantitative information drawn from their own internal risk management processes. In addition, the Basle Supervisors Committee is currently conducting a comprehensive survey and analysis of the 1994 derivatives disclosures in the annual reports of the top dealer banks in the Basle member countries. A report by the Basle Supervisors Committee is expected later this year on ways of improving these disclosures. IOSCO has also indicated an interest in joining in this effort. Any joint document arising from such a common effort should significantly advance the interest of enhanced disclosure of the effects of new products on the risk profiles of both banks and securities firm, and should result in greater consistency and comparability in these disclosures over time.

Furthermore, there are opportunities for greater convergence in accounting rules for banks and securities firms -- particularly for their financial products -- by aligning U.S. bank regulatory accounting rules with generally accepted accounting principles ("GAAP"). Currently, securities firms prepare their regulatory financial reports on a basis consistent with GAAP, and the same holds true for regulatory financial reports and general purpose financial statements of bank holding companies. On the other hand, the regulatory accounting principles underlying bank Call Reports differ in certain respects from GAAP. For example, generally, for bank Call Report purposes, futures and forward contracts used as hedges must be marked to market, whereas GAAP permits the changes in the market values of these instruments to be reflected in earnings on a basis consistent with the income or expense of the items being hedged. Also, certain asset securitization transactions involving recourse that are reported as sales under GAAP are treated as financings for Call Report purposes. Thus, the assets, liabilities, equity, and earnings reported in bank Call Reports may differ from related items reported in financial statements and regulatory reports prepared in accordance with GAAP.

Eliminating these differences between regulatory reporting standards and GAAP will result in greater consistency between bank Call Reports and the financial statements and regulatory reports of bank holding companies and securities firms. Since bank Call Reports and bank holding companies' regulatory financial reports are generally available to the public, the elimination of so-called "GAAP/RAP differences" will make it easier for analysts, investors, and other users to understand Call Report information and compare it with related bank holding company information. At the same time, regulatory burden will be significantly reduced since banking organizations will not need to keep two basic sets of books. Any concerns about GAAP can be addressed by other means, such as by collecting supervisory information in memoranda items and by making adjustments to regulatory capital ratios, as appropriate. This is the approach that the Federal Reserve has used for the regulatory reports of bank holding companies for many years. Accordingly, I am hopeful that we will soon see the adoption of GAAP for bank Call Reports.

VI. Concluding Remarks.

To conclude and summarize, I hope this review of supervisory initiatives and accomplishments illustrates that supervisors are making concerted efforts to keep pace with market practices and financial innovations. Just as innovation poses new challenges to the industry, it also poses challenges to supervisors. Supervisors are responding and are making significant progress in adapting their existing supervisory regimes. In several important areas, supervisory initiatives seem to be running along parallel tracks and showing some headway in the difficult task of harmonizing supervisory regimes among different industries.

However, significant challenges still remain. *Disclosure* is one area where greater progress and harmonization could be beneficial. While the Fisher report significantly advanced consideration of the issues regarding disclosure, the report itself recognizes a lack of consensus on the appropriate disclosures of new products and activities and their effect on the institution's risk profile. This point is illustrated in last month's Federal Reserve Bulletin article that reviews the 1994 derivatives disclosures made by major U.S. banks. Although 1994 disclosures were found to be dramatically improved over 1993 disclosures, there was significant diversity of methods used by the top ten dealer banks in presenting information about their derivatives activities. While diversity in disclosure may be appropriate given the wide range of possible risk profiles, some harmonization may be necessary to facilitate analysis and public understanding. Hopefully, continued industry and supervisory efforts in this area will advance harmonization.

Accounting - The dearth of definitive accounting guidance for complex and sophisticated instruments and strategies is another area ripe for further private and public initiatives. The lack of definitive accounting rules for derivatives is particularly troubling -- we need to press forward to enhance our accounting framework for derivatives and achieve greater consistency in accounting treatment across various types of instruments.

Internal models - We also need to make progress on the use of internal models for supervisory purposes. In some ways internal model development is still in its infancy, particularly when stretched to bank supervisory and capital adequacy purposes. Moreover, the harmonization of supervisory regimes for bank and securities firms has even further to go.

In concluding, let me point out that while there are clear areas of supervisory harmonization underway, supervisory convergence in all areas need not be the overriding goal. Although supervisors may share objectives, the specific techniques used to promote sound practices, capital adequacy, and transparency need not be identical. Indeed, in some areas, more harmonization is not always the answer. Supervisory regimes must reflect the differences in the regulated industries' business practices and needs. One size regulation or supervision may not fit all. Moreover, some competition and supervisory differences may be healthy and provide for constructive experimentation. Harmonization does appear to be occurring where clear economic incentives are driving supervisors to recognize the effects of dramatic technological and financial innovation in the financial services industries. But supervision, like business development is, and I believe should be, an evolutionary process.