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Timothy F. Geithner, President and Chief Executive Officer

Let me start with a few general points about the overall state of the financial system.

Although the United States faces difficult economic policy challenges, on the available evidence, the core of the U.S. financial system today is in substantially stronger shape than it was 25 or even five years ago. Capital levels are higher. Asset quality is better. Risk is better measured and managed. Earnings and risk are more diversified and in some respects more stable. The infrastructure of the financial system is more robust. Risk is spread more broadly, across a more diverse range of financial institutions.

The major institutions are managed today to be in a stronger position to withstand shocks of the nature and magnitude of the last few decades of experience.

Alongside, and reinforcing, these improvements in the traditional measures of financial health, we have generally seen substantial investments in the control and compliance infrastructure within individual firms. Anti-money laundering regimes are better. The integrity of public disclosure is better. The capacity to manage conflicts of interest, to protect against fraud, to enforce suitability requirements are better. Internal governance provides better checks and balances. Compensation is better aligned with incentives to reinforce the importance of compliance and control.

These changes are impressive relative to the state of risk management and compliance practice in the recent past.

With respect to both financial resilience and the control infrastructure, the critical judgment we have to make about relative progress, however, is not simply whether we are better than we were, but the extent to which we’ve caught up with the shifting frontier of the challenge.

The systemic question is the degree of resilience achieved against the potential challenges of a necessarily uncertain future with perhaps less favorable macroeconomic outcomes.

And in assessing the adequacy of progress in the control and compliance infrastructure, the key judgment is the extent to which financial institutions have caught up with the greater demands that have come with the increased geographic and functional reach of these firms.

The improvements in risk management and internal controls are the result of both regulatory imperatives and a rational assessment by individual firms that more was necessary to protect the institution against a broader array of potential losses and reputational risks.

This progress has come with substantial resource costs. These costs are clearly large when measured against what firms typically spent a decade ago on risk management and control. The harder question though, is how to assess the costs relative to the greater risks they are aimed at mitigating and to measure the costs against the benefits of the improvements, both for individual institutions and for the system.

In making this assessment, there are a few general trends worth noting.

The profitability of financial intermediation seems reasonably healthy. This observation holds up even if one looks through the reduction in realized credit losses that are the result of better overall economic conditions. And it appears to be true for the best run U.S. financial institutions relative to their peers in other financial markets, where the regulatory burden is perceived to have increased less than it has in the U.S. over the past decade.

The pace of innovation in the U.S. financial markets seems reasonably robust. The explosive growth in the volume and type of credit derivatives is only one example of an overall picture of rapid evolution in U.S. finance, relative to past experience and to trends in other financial systems. This suggests that the incentives and opportunities for financial innovation that have characterized the U.S. markets relative to other mature financial markets remain powerful despite concerns about the impact of the changing regulatory burden.

And confidence in the integrity of the U.S. financial markets seems to be stronger—integrity in the sense of reduced vulnerability to illicit activity, the reliability of public disclosure, the effectiveness of the enforcement deterrence. This confidence is evident in the apparent willingness of the world’s savers to invest in the United States and in the ease with which enterprises can raise capital in our markets.

These are encouraging trends and they offer some help in assessing the balance we have achieved today between stability and integrity on the one hand and innovation and efficiency on the other.

This is not to suggest, however, that we have the balance just right. Many of the concerns expressed about the evolution in the overall regulatory environment are legitimate. Anyone involved in applying or complying with the more exacting standards now in effect around internal controls knows that they are not perfect—that they don’t always offer a reduction in risk commensurate with the cost of the effort. Our continuing effort to stay abreast of new sources of challenge and vulnerability imposes a changing horizon of expectation on institutions.

Those of us in the supervisory community need to recognize these problems and we need to be open to sensible suggestions for how to address them. And as we continually revisit the balance, we need to be particularly attentive to a number of concerns.

We need to recognize that we can’t design sensible requirements for U.S. financial institutions without a careful understanding of the broader global context in which they operate. This is true in designing a better capital regime. It’s true in our efforts to reduce the vulnerability of financial institutions to money laundering. It is perfectly appropriate for us to decide to hold U.S. institutions to higher standards than apply in other parts of this more globally integrated financial system. But our effectiveness in doing so depends, to a considerably greater extent than in the past, on complementary bilateral and multilateral initiatives.
We need to make sure that

- we do not try to take judgment out of the process of risk management and compliance—the judgment of managers or of the supervisors,
- we do not prescribe rules where the risk of the challenge can’t be captured by a rule, or could better be captured by a principle,
- we are open to a diversity of approaches to achieving our objective so that we allow for competition in the pursuit of effective approaches, and
- we remind ourselves that no effective risk management or compliance regime can or should eliminate risk.

We have to be careful that the necessary and desirable increase in management and supervisory attention to compliance challenges does not draw attention away from the classic safety and soundness requirements of risk management. These should not be competing priorities. The last several years of experience provides compelling evidence of the ways in which the financial damage caused by a compliance failure can be large relative to potential credit and market risks. And the investments in the internal control and compliance infrastructure are in many ways a necessary foundation for a credible risk management system. But the challenges in measuring and managing financial risks have become more exacting, and they require a continuing investment in resources and supervisory attention.

Let me conclude by highlighting two types of concerns in this area—concerns about systemic financial issues rather than compliance—that are the focus of our attention today. The first is about infrastructure in the OTC (over-the-counter) derivatives world. The second concerns stress testing.

The dramatic innovations in the credit risk transfer market offer very substantial benefits to our financial system. From the inception of this market, the growth in volume, and in the complexity of the instruments, outpaced improvements in the infrastructure that supports it. The substantial scale of unconfirmed trades and the prevalent practice of allowing trades to be assigned without the knowledge and approval of all parties are two illustrations of the extent of the gap between the present infrastructure and existing internal risk management systems, and the requirements of a market this important. We need to see a much more substantial collective investment by the dealer community to fix these problems.

We hosted a meeting at the New York Fed ten days ago with the major dealers and their principal supervisors to encourage progress in this area. I want to recognize in particular the support of the FSA (Financial Services Authority) and the SEC (Securities and Exchange Commission) in this effort.

On the basis of the work done in advance of that meeting, the discussion at the meeting, and in the days since, I believe we are making some headway.

Three important points:

- We expect all of the major dealers will move quite quickly to a regime in which trades are not assigned without the consent of all counterparties.
- We expect the major dealers will act to make it possible for the vast bulk of new OTC derivative transactions to be confirmed on a much shorter fuse.
- We expect to see a major effort to eliminate, in a reasonably short period of time, the now very substantial backlog of unconfirmed trades. Firms will report progress to their supervisors using common metrics.

Second, we continue to focus a substantial amount of attention on improving the sophistication of the risk management systems, particularly in terms of their ability to assess the vulnerability of the firm to risks not easily captured by models or that lie outside past experience.

This is the province principally of stress testing and scenario analysis. Here, the toughest challenges, even for the most sophisticated of the major firms, are to capture more quickly the exposure of the firm across its many different types of businesses and relationships to various types of concentration and other risks; to integrate better the combined effect of credit and market risk; to build a sufficient cushion into the capital buffer above the regulatory minimum and in liquidity management strategies to deal with the risk of a major shock to market liquidity; to calibrate limits sufficiently conservatively to withstand the effects of the failure of a major counterparty; and to compensate for the inherent limits in our capacity to assess the probability distribution of future returns and the scale of potential losses in the tails of the distribution.

Even with the improvements in the demonstrated resilience of the financial system, the changes in the market over the last decade make this central challenge in risk management harder. The greater concentration in the financial system means the systemic consequences of the failure of a major firm could be more acute.

The combined effect of the dramatic growth in the importance of a range of different nonbank financial institutions and the substantial increase in more complex instruments adds some uncertainty to how markets will respond in conditions of stress, even though the overall effects to date have been positive.

The substantial reduction in macroeconomic volatility achieved over the past two decades, and the apparent reduction in concern about the risk of future volatility, also complicate the task of risk management, by lowering the apparent risk—but perhaps not the true risk—in the overall exposures of financial intermediaries.

Together this means that central banks and supervisors and those charged with managing the major financial institutions that play such an important role in our economies need to recognize that requirements of effective risk management and control regimes are going to become progressively more demanding. And we need to make the investments necessary to stay abreast of those changes and get closer to the frontier of what is possible. This makes it even more important that we look for ways to address aspects of the existing supervisory regime that impose unnecessary costs or that force resources and attention away from the greatest potential sources of risk to the financial system.

Thank you.