REMARKS BY

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Thank you for the kind welcome. I appreciate the opportunity to be here today and share some thoughts with you.

I would like to focus on two specific risk issues: the expanding number and sophistication of financial instruments and exposure to market risk and, whether changes in the financial system are altering the character of systemic risk and weakening the traditional safeguards. My observations refer, of course, to our experience in the U.S.; the issues, I think, have global application.

Those of you who came today have a strong interest in two aspects of these issues which particularly concern the Federal Reserve: product innovation in the derivatives market and settlement risk in the foreign exchange market. I understand that this Symposium coincides with the introduction of a new currency option product by the Philadelphia Stock Exchange. While I can't comment on the specifics, I applaud the Exchange's "holistic" approach to product development. The potential market has been identified, the rules for participation in the market are set, and the avenues for completing the transactions at settlement are clear.

Often, new products are created by financial service firms to fill identified needs of a customer or customers without considering the full risks and consequences. Nearly every day we hear about a new financial product or a new twist on an old product, and each of these products carries with it risks that are as yet unknown -- to sellers and end-users alike. Recent

U.S. experience with "structured notes" and the sizable losses incurred by some investing in these instruments sound a warning bell for all of us.

It pays to look carefully at just what the "structured note" problem is telling us about risk and competition, and the challenges that the combination of the two present to participants in our financial markets today. The traditional focus on credit risk may have provided investors in these instruments with a false sense of comfort about the overall risks involved. Insufficient attention seems to have been paid to market risk and inadequate resources devoted to information systems capable of properly identifying and monitoring market risk. Further, the recent, historically low, interest rate environment has driven some to stretch for yield by taking on more risk in the near-term with inadequate concern about longer-term vulnerabilities that are also part of the equation.

The episode with "structured notes" illustrates that today, more than ever before, it is critical that a financial institution's internal safety net -- its risk management and internal control systems -- keeps pace with the risks presented by this dynamic financial environment, regardless of the institution's size.

There are several goals that every financial institution should embrace in the near-term:

- First, the development of a fully independent risk management staff and a strong internal control

environment. It is essential that skilled personnel are hired not only for the trading floors and risk management staffs, but also, for back office and internal audit functions.

- Second, the development and, in some cases, further enhancement of measurement and monitoring techniques for all types of risk, including market risk and credit risk resulting from either traditional lending activities or more complex trading and derivatives activities. An information system that is as sophisticated as a firm's marketplace activities is essential to risk management and to the development of effective stress testing and contingency planning capabilities.
- Third, maintaining the same awareness for risk and the application of the same rigorous discipline and controls in fiduciary activities as those on lending and trading activities.
- Fourth, even more fundamental is the critical assessment by the board of directors and senior management of an institution's appetite and tolerance for risk, ensuring that risk management and internal control systems are commensurate with that level of risk. Well-identified and well-used internal communication mechanisms and a clear pathway straight up the chain of command are essential.

Let me be clear here that my message is not intended only for those institutions on the cutting edge of financial engineering -- it applies to all size institutions, from the large to the not-so-large, whether they are involved in trading, trust activities, securities lending or private banking, and to all buyers as well as sellers of sophisticated products. All too often we have heard institutions say they were unaware that they were in a "risk" business and therefore had not considered the implementation of effective risk management systems and controls a priority. This thinking must change. Risk is inherent in all aspects of financial transactions and it is imperative that management philosophies, systems and controls evolve and adapt to this reality.

It appears that a number of non-financial firms have made their corporate treasuries profit centers, charged with taking financial risk to achieve financial rewards. Does this really make sense if corporate managements and outside directors are not equipped to control and monitor that financial risk? I think not.

I want to focus briefly on another aspect of risk management. It is self-evident that a full appreciation of risk cannot be developed without accurate information. Thus, there is little question in my mind about the urgency of achieving dramatic progress in the areas of financial disclosure and market transparency. A striking aspect of the markets this year has been the recurrent episodes of tremendous uncertainty as to the

exact nature of market forces at work and the size of overhanging positions. This uncertainty provided a fertile ground for rumors about forced liquidation of holdings and the financial health of individual firms, and created the potential for volatile and disorderly markets.

All of us know that there is no greater enemy of the marketplace than a loss of confidence -- whether in major market participants or in the market mechanism itself. And while the financial system has thus far withstood the turmoil without great damage, I think it would be a tremendous mistake for us to ignore the clear message we received about the inadequacy of information available to market participants. When even generally well-regarded firms can be the subject of sudden and intense doubt, we overlook the implications at our own peril.

I see a need for bold and ambitious disclosure standards and a challenge to the private sector to meet that need promptly. Our fundamental notions of what is proprietary information and what should be in the public domain must change. Knowing the appetite for taking risk and the ability to control it at individual firms is essential to understanding the risks associated with being a shareholder, a creditor, or a counterparty.

I agree with the view that this is an international, and not merely a domestic, problem. In September, the G-10 central banks released a discussion paper regarding disclosure of market and credit risk by financial intermediaries. The observations and

recommendations presented in this paper, known as the Fisher Report, provide a good foundation for discussion and, ultimately, progress on enhancing public disclosure practices. With similar efforts being undertaken in the private sector, I think it reasonable to expect significant progress in designing a coordinated framework for fuller and more meaningful disclosure within the year.

I strongly encourage all financial market organizations and other institutions to approach this issue as users of financial statements rather than as issuers; what we all need to know about others to be comfortable should drive the debate, rather than concerns about our own disclosures.

The second major issue I want to address is whether changes in the financial system are altering the potential for systemic risk and weakening traditional protections against it.

Generally, we think of two sources of systemic risk. The first is the failure of a major market participant and the potential disruption to markets and to other counterparties that such a failure could cause. As I noted earlier, continued progress in developing risk management systems at all major market participants, as well as more comprehensive capital requirements, can help to reduce this risk.

One of the most important safeguards we have against systemic risk is the appropriate management of liquidity risk -- both funding liquidity and the management of market access more

generally. Clearly, the marketplace over the last 20 years has been unforgiving for those whose capital and liquidity become strained. Our recent history of low interest rates and ample liquidity may have led market participants to underestimate the value of liquidity and the speed with which it can dry up. As trading volumes have risen, the potential demands for collateral and credit lines to support payment and settlement mechanisms in stress scenarios have grown. Finally, the recent months have reminded all of us that market liquidity and the ability to adjust positions can deteriorate quickly when markets are under stress.

A second potential source of systemic risk is a market dynamic in which a large initial price move can be deepened and sustained by positive feedback mechanisms, such as margin calls, program trading, dynamic hedging of options, or steps taken to control losses in leveraged positions, all the more when many market participants follow similar strategies. This year, for example, rumors and press reports suggested that some leveraged market participants were being forced to liquidate to meet margin calls. This reportedly is just what happened to the managers and investors of at least one hedge fund, with consequences that were felt in the mortgage-backed and Treasury markets. Ultimately it is these markets that bear the brunt of major market disturbances, as investors under stress seek liquid marketplaces to adjust their positions.

To get to specifics, I see as a critical element the need to address the risk of settlement failure in foreign exchange caused by temporal gaps, known as Herstatt risk.

An important contribution has come from the work of the New York Foreign Exchange Committee, which has tried to find a solution to Herstatt risk and open a dialogue with central bankers and the markets about the issue. Just last week, the Committee released a study on the ways banks have viewed settlement risk traditionally. The study also included recommendations about how private-sector market participants can help themselves reduce this risk.

Let me recap three of the most powerful conclusions of the study.

First, and most importantly, the study found that the duration of settlement risk is much longer than anyone previously thought. The internal procedures of each bank is the largest source of the duration of settlement risk. The study also showed clearly that these internal procedures, can be altered by the banks themselves in order to reduce their settlement exposures.

Second, the study found that netting is a powerful tool for active market makers. Legally binding netting of payments enables market makers to reduce significantly the enormous sums that are at risk on any given day.

Third, for most firms, the current finality rules of the local payments systems are an important factor in determining the extent of settlement risk. In fact, for firms operating with close-to-the-current-best industry practices, settlement risk could be decreased if full intra-day finality prevails. When it does, final payments could, if necessary, be made and reconciled much sooner. This change, in turn, would shorten the duration of settlement risk.

I found the Committee's conclusions quite thought-provoking. They show how much the private sector can do on its own to reduce foreign exchange settlement exposures by implementing many types of procedures that are already in existence. For me, I must admit, this result was a bit surprising, considering that when the Committee began its project, there was no useful summary of settlement practices in a number of countries, and no uniform definition of settlement risk. The Committee did find that much of the debate in the market about possible changes to global payments systems was not grounded in a clear understanding of the causes of settlement risk, and that many market participants have been quick to focus on solutions without a thorough understanding of the underlying problems.

The Committee used its findings to develop over a dozen recommended "Best Practices" to help the industry and individual banks reduce Herstatt risk. The report's recommendations were put forth in order to stimulate individual banks to act and to promote a dialogue on the issues involved. My intention today is not to endorse or reject any specific Committee proposal. I do, however, think they are worthy of discussion and consideration.

Clearly, resolution of these concerns can be achieved only through a high level of international cooperation and agreement. My goal is to make substantial progress during my tenure as chairman of the Payment and Settlement System Committee established by G-10 central bank governors. I'd like to think that the combination of private and public attention to this

issue could mean the elimination, or at least the near-elimination, of Herstatt risk. After 20 years, that goal is long overdue.

There is little question that the foundations have been laid, but now must be built upon and enhanced to reflect the growing complexities of our financial system. At the end of the day, while our perspectives of the risks and challenges may differ, our objectives as supervisors and your objectives as financial intermediaries and users of financial services are the same, pointing toward maintaining a vibrant and strong financial system over the long-term.

I appreciate the opportunity to talk with you today. In many respects the interests of the exchanges and the central bank coincide. We want to encourage financial market innovation without compromising the elements which are essential to sound and orderly markets. Exchanges in the United States have proved repeatedly that prudent risk management and controls need not hamper creativity. The new instruments and services that exchanges introduce often make valuable and lasting contributions to the development of our capital markets.

Thank you very much.

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