Federal Financial Institutions Examination Council
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Risk Management

Good morning. I'm Bob Parry, President of the Federal Reserve Bank of San Francisco. It's a great pleasure to welcome all of you to this Conference on Risk Management Planning.

For some people, risk management today has become synonymous with sophisticated instruments like swaps, caps, options, and a host of other derivatives. In the U.S., a dozen or so banks serve as market-makers in derivatives, and many more banks and thrifts are end-users. This "brave new world" of sophisticated tools and techniques has arisen in part because of advances in computer technology and finance theory, and it has brought risk management to a new level.

But I think it's important to remember that risk management is much <u>more</u> than high-tech tools and techniques. It's also a very basic process—and it includes setting objectives, planning, establishing procedures, and gathering information. Finally, even with all the new tools and techniques available today, effective risk management still requires plain old good judgment. These are the important dimensions of risk management you'll be looking at in the sessions today and tomorrow rather than the "rocket science" aspects of risk management.

In that spirit, I'd like to address three aspects of risk: the goals of risk management, its heightened importance today, and finally the role of regulators in risk management.

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I. Let me start with the goal of risk management. The goal is not to eliminate risk. After the very grim experiences of banks and thrifts in the late 1980s and early 1990s, I think we've seen some unfortunate overreaction in this direction. Now, I don't mean to say that there aren't plenty of reasons to pause to assess risk among banks and thrifts. The high rate of bank and thrift failures and the billions of dollars of losses to the federal deposit insurance system in recent years have raised justifiable concerns about the level of risk in the banking and thrift industries. In addition there's some evidence suggesting that operating risk—among banks at least—has increased over the last decade or so. By operating risk I mean nonleverage risk like credit risk, interest rate risk, exchange rate risk, and portfolio- concentration risk.

Nevertheless, risk management should not mean squeezing all of the risk out of banking. On the contrary, to be viable, banks and thrifts have to be able to take risks. Risk is part and parcel of the day-to-day decisions banks make regarding funding, extending loans and credit guarantees, or writing future contracts. Risk also is an unavoidable part of decisions to merge, to open new branches, or to expand the scope of services. More fundamentally, risk is an elementary part of our economic system and a necessary aspect of improving our standard of living.

What does risk management mean then? One thing it means is choosing appropriate risks. It means taking risks that are

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justified based on the expected return, and avoiding unnecessary risks—that is, risk-taking that's not rewarded by the market. On the lending side, for example, avoiding unnecessary risk means pooling credit risk by taking advantage of available diversification opportunities. For banks—and especially for thrifts—that will never mean full diversification; the comparative advantage banks and thrifts have in lending means they'll always have some degree of specialization that naturally limits diversification. Nevertheless, the experience with energy loans in the early 1980s and to some extent the impact of the more recent problems in commercial real estate are reminders of what can happen when asset portfolios are too concentrated.

Another part of risk management, of course, is knowing the extent of your risk exposure—that is, accurately assessing and measuring risk. In the case of credit risk, for example, this means properly assessing the risk of individual loans. But importantly, it also means understanding how the expected returns on individual assets are correlated. For the most part, institutions do a good job of evaluating credit risk. But there <u>have</u> been problems. We've seen breakdowns in credit evaluation procedures in certain cases of banks and thrifts that have been bent on rapid growth. Also, many analysts think that some lenders missed earlier warning signals of problems in commercial real estate in the late 1980s.

II. My second point is that risk management is becoming increasingly important. One reason is the increased competition

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in the financial industry. The traditional activities of banks and thrifts such as deposit-taking and lending have been losing ground to direct market financing and to competition from nonbanks. Securitization, for example, has dramatically changed the way single-family homes are financed and has had profound implications for thrifts. Likewise nonbanks are going head-to-head with banks. Firms like Merrill Lynch, for example, don't just market mutual funds and underwrite securities—they also make consumer and business loans. In addition, the growth of financial services is expected to occur not in the traditional areas of banks and thrifts, but in areas like mutual funds and annuities, where the field already is crowded with nonbanks. This heightened competition means that pricing is being done on thinner margins. And that puts a premium on properly assessing risk to be sure that deals pencil out. There's just less room for error.

III. Finally, let me turn to a somewhat different slant on risk management—the role of the regulators as risk managers. This role stems mainly from two related considerations -- concern over systemic risk and the presence of the deposit insurance guarantee. The potential for systemic risk means that even if private risk is managed well, the financial system as a whole may still be exposed to too much risk. I think this is why the dramatic growth in derivatives, for example, has raised concerns in regulatory circles. It's not so much that individual institutions can't manage the direct risk they associate with

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derivatives—or even that derivatives by themselves are a source of instability. Rather, the main concern revolves around the fact that derivatives complicate the linkages among institutions. With more complicated linkages, a shock in financial markets could spread more quickly and more unpredictably. This would make the system more vulnerable to instability. At this point no one can say how serious this is, but it is a concern.

Of course, deposit insurance is designed to address some of the instability associated with systemic risk. But deposit insurance also creates its own reasons for regulatory risk management. That responsibility is to keep the insurance guarantee from unduly influencing credit decisions--that is, to keep the guarantee from giving insured institutions any incentives to take on excess risk. Our goal is to try to control the value of the deposit insurance guarantee to individual institutions, which translates into limiting the risk exposure of the deposit insurance system.

Our efforts have three facets. The first is checking on the risk management procedures of individual institutions. In this regard, the role of the regulator first and foremost should be one of evaluating procedures, rather than one of specifying procedures. This is the spirit behind the Fed's proposal for dealing with interest rate risk; it lets institutions use their own internal models for measuring risk. I think that's the right way to go, because regulators just aren't in a very good position to write "cookbook" solutions to banks' and thrifts' risk

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management problems.

Now, I certainly recognize that regulations can be a lot more intrusive than banks and thrifts might like. As in the case of FDICIA, for better or worse, we have laws that provide for regulations directly affecting individual institutions' management of risk. Other regulations restrict activities. The irony to me about this is that, while limits on bank powers often are justified as necessary to limit risk, the restrictions often may be doing more to limit the scope of risk management. A case in point is the restriction on interstate branching.

The second facet of regulatory risk management is capital regulation. Put simply, the regulator's role here is to require banks and thrifts to hold sufficient capital to absorb expected losses. That is, we regulators are trying to control overall risk by balancing the higher operating risk of an institution with higher capital.

But even here, our goal is <u>not</u> to eliminate failures, just as the goal of banks and thrifts is <u>not</u> to eliminate risk. Failures happen. Even well-run banks and thrifts, with sound risk management, can be hit by bad luck and fail. More importantly, failures are a necessary dynamic in virtually every industry because they ensure that inefficiency and mistakes are weeded out.

In fact, the third facet of risk management for the regulators is the set of procedures for handling institutions that do find themselves in trouble. This is an area where

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regulators could have done a better job in the past. I think that the earlier short-comings were due in large part to the incentives regulators were given to keep troubled institutions afloat. I am hopeful that recent changes calling for prompt corrective action by regulators are providing more appropriate incentives and will prove to be more effective.

Let me conclude by saying that I've had a chance to look over the agenda and some of the materials that you'll be working with today. I'm particularly impressed by the specific objectives that this seminar is supposed to achieve, namely improving your ability to identify, measure, and manage risk.

So, once again, I'm very pleased to welcome you all here, and I'm sure you're going to get a lot of good, practical help in improving your risk management over the next couple of days.

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