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## Keynote Address: Hon. Susan M. Phillips, Member, Board of Governors of the Federal Reserve System

Susan M. Phillips

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**KEYNOTE ADDRESS:**  
**HON. SUSAN M. PHILLIPS**  
**Member, Board of Governors of the**  
**Federal Reserve System**

PROF. RECHTSCHAFFEN: Welcome to the afternoon session of the Fordham University School of Law Symposium on Derivatives and Risk Management.

In the morning session we discussed the goals of this symposium. We discussed the free interchange of ideas—the ability to speak among regulators and market participants. Our keynote speaker for this afternoon is the embodiment of these goals. Taking time out of her schedule as a Member of the Board of Governors of the Federal Reserve System to be with us for lunch, to talk to the students, to talk to the participants, to speak with us now, to listen to the other regulators, and possibly to take part in a discussion at the end of the day, demonstrates her commitment to balancing the interests of those involved in the risk management industry—the regulators, the derivative market participants, and the next generation—the students.

One of my students commented to me that Governor Phillips is a regulator who recognizes the role of regulation and the ability of free markets to serve the public good.

Dr. Susan Phillips was sworn in as a member of the Board of Governors of the Federal Reserve System in 1991. Before becoming a member of that Board, Dr. Phillips was a professor; she was a vice president at the University of Iowa; in 1981 Dr. Phillips was appointed as a member of the Commodity Futures Trading Commission; and, if that wasn't enough, in 1983 became its Chairman.

Dr. Phillips's areas of specialization include options, commodity futures, financial management, and the economic theory of regulation. She is the author of many scholarly publications, and perhaps the person in the world who is the greatest beacon in the field of risk management regulation.

It is my distinct honor and privilege to introduce to you the Honorable Susan M. Phillips, Member of the Board of Governors of the Federal Reserve System.

DR. PHILLIPS: That was really quite an introduction. I'm most flattered. It sounds like my staff did a good job sending you things.

First of all, let me say it's a great pleasure and honor for me to be able to come to Fordham University and the School of Law and spend Friday afternoon with you. I always like an opportunity to get out of Washington, and particularly to come to a university and spend some time with students and faculty. It affords me an opportunity to sort of step back and think about some of the policy issues that we are strug-

gling with and try to put some of it into perspective, and I very much look forward to the discussions that follow our sessions this afternoon.

The topic, of course, of the seminar today has to do with derivatives and risk management. These two topics have certainly attracted wide attention among the public and market participants—and the government, for that matter—over the past several years and, I suspect, will continue to do so for a number of years to come.

Clearly, financial engineering and improvements in risk management have helped the financial industry to offer products to their clients to better control various types of business risks. At the same time, financial institutions also benefit from these innovations. They can better manage the risks associated with complex financial instruments and a growing volume of financial transactions.

As you know, risk management is, of course, the process for identifying, measuring, reporting, and then controlling risk. Now, while this term has been recently popularized by the financial press, the root concepts of risk management are not new to the financial industry. Indeed, by taking risk or acting as an intermediary in transferring risk, the financial industry fulfills a role that has been and continues to be vital for economic growth. I think it's fair to say, however, that the process of risk management has become much more quantitative in the last few years.

Turning to derivatives, this also is not a recent innovation. Derivatives markets, such as those involving futures contracts, have existed for decades—in fact, quite frankly, for centuries—for some kinds of price risks. The trends in financial engineering that we have been seeing in recent years are really the fruits of technological progress, reduced costs of product innovation, and increased feasibility of applying financial theories that require intensive computational power.

Along with the technological progress that has made all of this possible, financial engineering has profoundly affected the structure of many of our leading banks. These processes, I think, continue to reverberate throughout the industry. Banks engineer new products to shift business risks to others that had previously been routinely borne by the bank itself.

The reverse side of the coin, of course, is that market participants can assume risks through alternatives to the traditional lending and investing avenues. For example, credit derivatives, which are in the nascent stage of development, may someday lead to banks being able to trade and adjust the credit risk associated with commercial bank loans about as easily as they are able to change the risk profile of their bond portfolios.

Prior to these innovations, institutions could be generally compartmentalized into market segments that did not directly compete with

one another. Government regulation mirrored and reinforced this segmentation.

With financial innovation have come new levels of competition, which, in turn, have caused pressure for government to change the rules of play. As a result, the legal strictures preventing banks from engaging in certain kinds of businesses are being loosened. Banks are increasingly in direct competition with securities firms, and also perhaps, now with insurance companies.

New technology and financial innovation have clearly affected the way in which many firms manage their businesses. They have also put stress on many aspects of traditional legal, regulatory, and accounting frameworks.

Over the past decade, bank supervisors have learned some important lessons in this regard, and I think it is these lessons that are propelling our efforts to adapt our supervisory and regulatory regimes to better accommodate the changes underway in the financial sector. In a sense, this is a move to a new supervisory paradigm.

Today I would like to briefly summarize some of these lessons and illustrate how they are shaping the evolution of bank supervision, and then offer some thoughts on how these lessons may also actually now be affecting international supervision as well.

Perhaps the most basic lesson that we have learned from our experience in supervising trading and derivatives activities is that the underlying risk of the financial instrument is much more important than what the instrument is called. Although two instruments that differ in name only may have entirely different treatment under existing—and perhaps outmoded—legal and regulatory frameworks, the market, credit, liquidity, operational, and reputational risks that are embodied in them actually could be identical.

To be sure, financial engineering can create derivative instruments that combine risks in very complex ways. But upon analysis, traditional cash instruments that appear simple may actually have greater risk than the complex instruments that are labeled “derivative.” Indeed, placing financial instruments into pigeonholes, without regard to their true underlying risks or their economic functions, can create disincentives for prudent risk management—often with unfortunate results.

The structured note phenomenon of 1993 and 1994, I think, is an important example. Many institutions shunned derivatives in favor of these seemingly low-risk securities that were issued by federal agencies, only to find out later that these very same instruments had significant price volatility from embedded options. The reaction of many was to label these structured notes as “derivatives” as well, rather than understanding that it was the underlying risk characteristics that had been poorly managed. It was really a question of risk manage-

ment and how these instruments could appropriately be allocated into the overall portfolio.

In its supervisory role, the Federal Reserve is increasingly emphasizing the need for managing the aggregate or portfolio risks of banking, as opposed to looking at specific instruments. For example, in 1993 we issued examiner guidance on trading and dealer activities. This guidance covered a large spectrum of financial instruments, including derivatives. The risk management principles under examination applied whether or not the institution was using derivatives.

We addressed structured notes in similar fashion in 1995, with guidance on the risk management of bank investment and end-user activities. More recently, the Federal Reserve issued examiner guidance on the risks relating to banks' management of secondary credit market activities, including securitization activities, the extension of various types of off-balance sheet credit enhancements, and also the use of credit derivatives. The guidance stresses the importance of internal capital allocation schemes and risk management schemes that accurately reflect the economic substance of transactions.

A second lesson that has been, I think, reinforced over the past several years, is that risk must be measured and managed comprehensively. That is, the focus should be on the dynamics of the portfolio rather than on specific instruments, which can ignore the interplay among various instruments.

Although portfolio theory is widely appreciated, I think, by bankers and regulators, putting its principles into practice in banking has not been that easy. Past banking crises have, in part, reflected a failure by some institutions to recognize and limit concentrations of risk within their portfolios. However, technology and financial innovation are enabling banks to put theories and conceptual techniques into practice to manage market and credit risks involved in trading, investment, and lending activities. Most dealer banks now routinely employ value-at-risk measures to manage market risks of trading portfolios, and significant strides are being made in the quantitative measurement and management of credit risk.

The move to a portfolio-based approach to managing risk has influenced bank supervisory efforts in several ways. All three of the U.S. banking agencies<sup>1</sup> now take a more risk-focused approach to supervision. This is simply allocating more supervisory resources to a bank's activities that pose greater risk. For example, bank examiners no longer exhaustively review all of a bank's activities. Instead, the examination approach is now to identify and review the sources of risk within a bank's various lines of business.

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1. The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve Board.

The need to measure risk on a portfolio basis has also begun to be reflected more explicitly in our capital guidelines and our reporting requirements. Beginning next year, internationally active banks meeting certain criteria for risk management will calculate the amount of capital necessary to support the market risk of their trading activities using their own internal value-at-risk ("VAR") measures. This approach allows banks to make use of empirical correlations among risk factors when computing VAR models.

A third lesson from our experience with derivatives and other financial innovations is the critical importance of a firm's internal processes for controlling risks. This, of course, is the most obvious lesson that has been learned from some of the spectacular losses that the press has put under the rubric of "derivatives debacles." Supervisors, both here and abroad, are focusing more on reviewing the adequacy of internal controls and management processes, such as enforced risk limits. These are key to gaining maximum benefit from financial innovation while at the same time avoiding missteps or misadventures or accidents.

The final lesson that I want to talk about is the need for supervisory and regulatory policies to be more incentive-compatible. Now, by that I mean that they foster sound risk management within the institution, rather than a narrow adherence to rules and regulations. Incentive-compatible supervision and regulation minimize burdens by using internal risk measurement systems and are reinforced by market forces and the performance incentives of bank owners and managers.

Too often financial engineering is targeted at regulatory arbitrage—that is, exploiting loopholes in narrowly focused regulatory policies that are based on old, traditional instruments or business lines. Also, potential new products may not be introduced because their regulatory treatment is viewed as too burdensome or uncertain.

This situation demonstrates all too clearly, I think, the differing reaction times of the public and the private sectors. Regulatory policies and standards often take a long time to change, whereas in the private sector market forces can quickly remedy outmoded standards. The resulting distortions of resources that can arise when regulatory or supervisory standards are slow to change, I think, is an unfortunate—albeit predictable—outcome.

Policy makers, I think, can reduce this potential distortion by structuring policies to be more incentive-compatible. This involves harnessing market forces—market discipline—to achieve supervisory objectives. Increasingly, supervisors are trying to avoid locking themselves into formulaic, "one-size-fits-all" approaches to supervision and regulation. The use of internal VAR models for calculating capital charges for trading activities, I think, is an important step in this direction.

Risk-focused supervision emphasizing sound practices and internal controls is another. A significant effort that could increase supervisory reliance on market discipline in the future, I think, could be the Federal Reserve's so-called pre-commitment approach to determining capital from market risk. This approach seeks to provide banks with stronger regulatory and market incentives to improve all aspects of market risk management. This approach actually now is being tested and studied by a group of U.S. banks organized by the New York Clearing House, and we are anxiously monitoring and watching the results of this experiment.

Well, what will be the eventual outcome of incorporating these lessons into banking supervision? I see that there are really two themes that seem to be emerging in the evolution of the supervision of financial institutions.

First is providing strong regulatory incentives for banks to exercise prudence in taking and managing risk, and to continue to develop ever better systems and processes for risk management.

I believe the best evidence of this thinking is illustrated by the recent moves to align regulatory capital requirements for market risk with individual institutions' own systems for allocating economic capital based on internal models. Supervisory oversight then concentrates on the performance of each institution's risk management process, rather than devising regulatory capital schemes that may not fit every institution and, inevitably, are going to have loopholes or inconsistencies that can be exploited.

The second theme that I would mention is that greater reliance will be placed—particularly for non-bank business lines—on the discipline the market can exert on individual participants. The latter element to our supervisory approach depends on market participants acting in their own self-interest when dealing with their counterparties. That involves understanding the risks of engaging in business and properly pricing transactions.

Reliable financial information is an essential ingredient to efficient market discipline. Such information would clearly convey the risk profile of the institution it represents. In its absence, markets are more susceptible to distortions caused by rumors, misinformation, or failures to disclose. Many believe that the dearth of information on risk profiles reflects the market's reliance on the federal safety net. Such information would be available if participants were not to a large extent indemnified from loss.

It is this desire to see market discipline taking a greater role in regulating the affairs of banking organizations—and others, for that matter—that has motivated the Federal Reserve Board to voice its opinions about accounting standards that are being developed by the Financial Accounting Standards Board.

As in regulation, an important consideration in setting accounting standards should be that the benefits of a particular standard outweigh its costs. The Federal Reserve's opinion is that the accounting for derivatives—and other financial instruments, for that matter—should be consistent with the approach to risk management the firm takes in its business. This consistency can yield cost savings by reducing the need for two sets of books, one for financial reporting and another that supports internal management decisions. Moreover, it avoids the possibility of regulatory reports diverging from financial reporting, thereby helping to ensure that supervisory information and capital requirements appropriately reflect the institution's economic risks.

The challenges of supervision in a rapidly changing financial and technological environment actually are compounded by global integration in the marketplace. To the extent that regulation in one country is deemed too restrictive, firms can avoid it by simply booking business in another country.

The ease with which firms can circumvent national borders and regulatory jurisdictions is a challenge of one dimension. If circumvention, however, results in unsafe or unsound banking problems, it is a problem of another dimension, and that problem may well end up back in the United States anyway.

It is for these reasons that the Federal Reserve and the other banking agencies have been advocating that international agreements on banking supervision have a risk focus. For example, the Basel Committee on Supervision, under the auspices of the Bank for International Settlements, recently agreed to embrace a portfolio-based risk-sensitive approach to setting capital requirements for market risk. Supervisors will be building upon the processes banks use to measure trading risks. This should substantially reduce regulatory burden and make the standards more compatible with industry practice.

In addition, the Basel Committee has agreed to common frameworks for gathering information on the derivatives activities of supervised institutions. A major task before us is to work with emerging market countries to strengthen and unify banking supervision. Greater consistency should reduce the risk of systemic problems arising from a financial disruption in any particular market.

While most of these efforts have focused on market risk, I think it is fair to point out that the major exposure for most banks remains credit risk.

Looking to the future, will the risk-based approach for capital or credit risk ever evolve into an internal models approach? Well, the answer is probably yes. However, with credit risk modeling in such an early stage of development, it is premature to predict just when credit modeling—and the supporting data, for that matter—will develop to the point that they can be relied upon as effective management tools.

I must say, however, that I am encouraged by the progress in modeling credit risk that we are seeing. The risk-based capital accord has worked well in the past, and I think it remains useful today. It was an excellent vehicle for bringing about a convergence in bank capital standards worldwide. But it does illustrate the problems of a standardized scheme. For example, banks have an incentive to securitize low-risk assets to avoid regulatory capital charges that unregulated competitors need not meet.

Alternatively, market participants can get a false sense of security about a bank's condition if the risk-based capital ratios understate the true risks of a bank's portfolios. Recognizing these shortcomings, we regulators continually need to review and revise our standards, as we have, for example, in connection with the securitization of certain assets.

Some of you in the audience may be a bit surprised that my remarks on derivatives end with a discussion of risk-based capital, but this to me illustrates the unexpected effects of financial innovation. A decade ago, I think, few would have predicted that techniques for controlling risks might point the way for measuring risks in lending and allocating capital, but that is the very nature of innovation. Those who identify new ways to apply lessons learned in one area to other activities are the ones most likely to succeed.

Taking risk is unavoidable in banking. Indeed, bankers must do so to survive. The key is to identify, manage, and control risks that are inherent in the business. The intelligent use of derivatives is one way to accomplish that. But one should focus not on derivatives in and of themselves, but on their role and effect on the bank's overall portfolio.

Thank you very much.