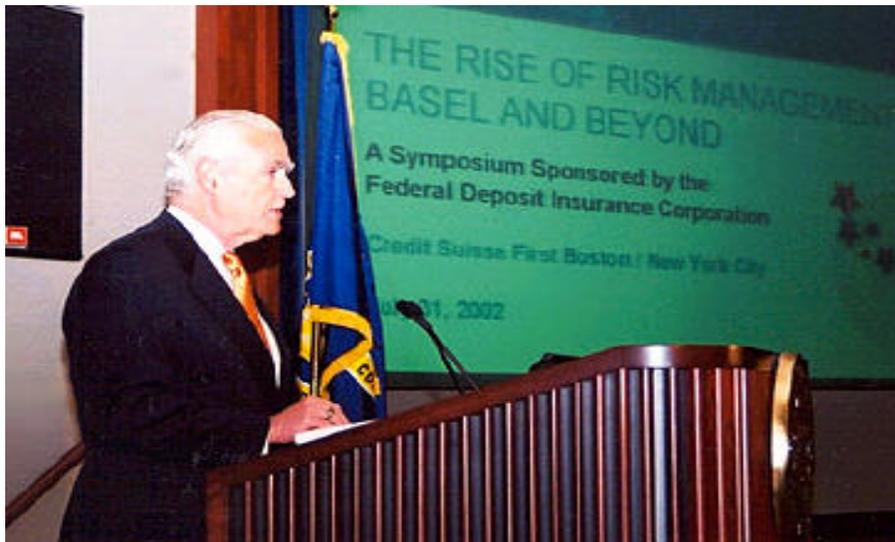


WASHINGTON, D.C.

MARY GARNER  
(202) 898-6594  
[mgarner@fdic.gov](mailto:mgarner@fdic.gov)

**“The Rise of Risk Management: Basel and Beyond”  
A Symposium Sponsored by the FDIC  
Hosted at the New York, New York  
Headquarters of Credit Suisse First Boston  
July 31, 2002**

*Banks, brokerage firms, government sponsored enterprises (GSEs), and other financial institutions are becoming more complex and their risk management decisions must sufficiently address these complexities. Presently, regulators and financial institutions are addressing the importance of appropriate risk management policies and procedures by embracing a second Basel Capital Accord. Top government officials and leading experts from Wall Street, the business sector, the accounting profession and academia gathered in New York City on July 31, 2002 to discuss these issues in detail at the "Rise of Risk Management: Basel and Beyond" symposium sponsored by the Federal Deposit Insurance Corporation (FDIC) and co-sponsored by Credit Suisse First Boston. This Bank Trends report summarizes the remarks of symposium participants, but does not necessarily express the views held by the FDIC.*



FDIC Chairman Donald Powell affirms the FDIC's commitment to work jointly with the industry and regulators to promote effective risk management.

# **“The Rise of Risk Management: Basel and Beyond”**

## **A Symposium Sponsored by the FDIC**

### **Hosted at the New York, New York**

### **Headquarters of Credit Suisse First Boston**

#### **Opening Remarks**

Richard Thornburgh, Credit Suisse First Boston’s (CSFB) Vice Chairman of the Executive Board and Chief Financial Officer opened the discussion by citing the timeliness of the conference given the recent announcements from the Basel Committee on Banking Supervision just a few weeks earlier. He stated that CSFB places a premium on effective risk management practices and supports the ongoing efforts of the Basel community. While CSFB supports the Basel initiative, he noted that issues involving operational risk, pro-cyclicality, calibration, cost and complexity still concern the industry and stressed that the United States needs to be more vigilant to emphasize transparency. He went on to say that the industry relies on its regulators to ensure a fair and honest financial system in the United States, with the quality of supervision having played a key element in U.S. markets being the deepest, most liquid markets in the world.

To that end, he introduced the symposium’s kick-off speaker, FDIC Chairman Donald Powell. Chairman Powell stressed the importance of cooperation between the banking regulators and the industry as the Basel process moves forward. To be effective, senior management must play an active role in risk management. He discussed the FDIC’s interest in forming a close partnership with the industry in order to reach a mutual goal – a healthy, safe and sound banking industry. Regulators must be able to properly evaluate banks’ risk management practices and ensure that models produce appropriate results that provide viable options for the decision makers.

Chairman Powell stressed the need for transparency in financial markets. To that end, he announced that the FDIC would form a working group on enhanced disclosures by banks. He emphasized that the group would be comprised of both members of the financial services industry and regulators working together to recommend a disclosure policy around four principles: 1) to provide the markets access to important and timely information so investors can make sound decisions and impose market discipline; 2) to enhance the safety, soundness, and stability of the financial system; 3) to ensure that a level playing field on disclosure is maintained between U.S. banks and their overseas competitors; and 4) to ensure the proper and timely implementations of the proposed new Basel Accord.

#### **Panel One: Risk Management in Complex Institutions: A Progress Report**

The first panel of the symposium highlighted current risk management practices at financial institutions. Thomas (Todd) Gibbons, Chief of Risk Management at The Bank of New York (BONY) began by discussing current issues in risk management. Mr. Gibbons believes there has been more development of sophisticated credit risk modeling, but that there is considerable room for advancement. He noted several improvements in BONY’s new risk management system. For example, the new system is more granular, meaning that risk is more finely assessed, with 18 grades of probability of default and 12 grades for estimated loss given default. Therefore, each loan can be categorized into one of 216 possible risks, allowing BONY to more accurately assess whether it is being adequately compensated for the risks that it assumes. In response to a question, Mr. Gibbons noted that while modeling was rightly

assuming a more important role in risk management, the bank “does not manage to a model.” Overall, Mr. Gibbons stated that the industry was doing better with its risk management, but “we still have a long way to go.”

The next panelist, Robert Dean, Senior Vice President of Market Risk Oversight Freddie Mac, focused his remarks on the measurement of market risk. Mr. Dean noted that the market has been more volatile in recent years, with the frequency of high stress, high volatility market environments increasing. Mr. Dean noted that value at risk (VaR) does not take into account many attributes of an unstable market. He suggested that the conventional VaR needs to be adapted to capture additional risks, including modeling error and liquidity risks. The goal is to try to calculate the unexpected loss or the potential for the market to be wrong, which is more likely to occur in high-stress environments. In response to a question, Mr. Dean acknowledged that Freddie Mac holds greater economic capital against similar portfolios than before.

Next, Evan Picoult, Managing Director of Risk Methodologies and Analytics, Citigroup cited three crucial aspects of risk management. First, Mr. Picoult stressed the importance of having a consistent method for measuring risk and consistent policies for the management of risk across the firm. Next, he stated that the critical aspect of risk management is the integration of risk policies and practices into business decisions. The third aspect he noted concerns both the way risk measurement is structured and how functions are defined. Structural issues, such as whether risk management should be centralized or decentralized, should be considered. Mr. Picoult also mentioned that in some instances, perverse performance incentives caused excess risk to be taken by a bank. In his view, managers were rewarded for generating revenue without consideration for the risks they were taking.

The final panelist was Robert Tortoriello, partner with Cleary, Gottlieb, Steen & Hamilton. Mr. Tortoriello highlighted the critical role for legal and compliance personnel by assisting management in identifying, monitoring, and mitigating various types of risks. The legal/compliance function must establish and implement a written compliance program relating to federal and state banking and securities law. He noted that the new Sarbanes-Oxley law only

underscores the responsibility to disclose important developments, articulate accounting assumptions in an understandable way, properly analyze and execute off-balance sheet transactions, and properly disclose loans and other exposures to executive officers and directors. Finally, Mr. Tortoriello stressed the involvement of the legal and compliance functions in how a bank structures, discloses, and implements risk management practices.

## **Panel Two: Road Ahead: Risk Management and the New Basel Accord**

Panel Two focused on risk management and the implications of the new proposed Basel Accord, also known as Basel II. The first panelist was William L. Rutledge, Executive Vice President for the Federal Reserve Bank of New York. Mr. Rutledge stated that under Basel II bank supervisors are emphasizing the need to understand and assess a bank’s internal processes, rather than focusing simply on a bank’s condition at one particular point in time. While Mr. Rutledge believes that competition and other factors would cause the quality of risk management to continue to rise, he feels that Basel II adds further encouragement to the improvement of risk management practices. The most significant advance in the new Accord is the application of an internal ratings-based (IRB) approach to credit risk. Mr. Rutledge stated that U.S. supervisors have embarked on an interagency pilot program that will help to prepare for the implementation of Basel II. The program is intended to help the regulators learn how to conduct internal ratings reviews and to evaluate banks’ current readiness to adopt an internal ratings-based approach to monitoring credit risk. Finally, Mr. Rutledge discussed the upcoming October 2002 launch of the Committee’s third “Quantitative Impact Study” (“QIS 3”), through which banks worldwide will estimate the effects of the proposed new rules on their capital levels.

The next panelist, Karen Shaw Petrou, Managing Partner of Federal Financial Analytics, had a considerably different take on the appropriateness of the Basel initiative. Ms. Petrou said that she has significant concern with Basel II, not because the

individual pieces of it are necessarily wrong but because “nobody understands how it all works together.” Ms. Petrou stressed that reliance on models on which the Basel rules are based must be evaluated with tremendous caution and a careful look at the bottom line. She also highlighted problems with the operational risk rule. Reputation risk is not included in the Basel definition of operational risk for purposes of determining a capital requirement. As another weakness of the Basel II proposal, Ms. Petrou stressed the difficulty with relying on models. She suggested that the Basel Committee move forward only with the provisions of the rule on which there is widespread agreement and considerable evidence of immediate need.



Ms. Petrou discusses her concerns with the implementation of Basel II, noting that no one understands how the entire proposal will work together.

The next speaker was D. Wilson Ervin, Managing Director of Strategic Risk Management with CSFB. Mr. Ervin stated that Basel II might be too complex, noting that the cost benefit ratio would depend on

how the rules are applied. If these requirements are each held to a rigid audit standard, both banks and supervisors would experience very large additional costs and both would have to hire many auditors to review and enforce this rule. For example, there are 80 separate requirements that must be met in order for a bank to use the advanced internal ratings-based approach to credit risk. He suggested that supervisors allow banks to address 80 percent of the requirements that matter most to a bank and that the incremental benefit from complying with the last 20 percent may not be sufficient to justify the added expense. Mr. Ervin emphasized the importance of Pillar II and noted that if the costs of Basel II end up being too high, banks may have some incentives to de-bank. He also highlighted the problems with the proposed quantification of operational risk in Basel II, stressing that quantification of operational risk could create a false sense of security that operational risk had been measured, and thus controlled. He discussed another concern with the Basel initiative the pro-cyclicality of the rules. He noted that the new rules promote more risk sensitivity and assign higher capital to higher risk classes, which should encourage a better return on capital. However, he cautioned that bank capital tends to be hit hard during economic recessions and suggested that Basel II would have banks cut back on lending during a recession. Mr. Ervin concluded his remarks by saying that unless the current proposal is streamlined significantly, there would be a real risk that the mass of the new rules may outweigh the potential benefits.

The final speaker on this panel was Adam Gilbert, Managing Director of Corporate Treasury Group at J.P. Morgan Chase & Co. Mr. Gilbert outlined five main benefits of Basel II: it will differentiate borrowers by internal or external ratings, it will create more incentives to hedge credit risk and to hedge operational risk, it will recognize more forms of collateral, it will factor correlation into the regulatory model in a much more explicit way by recognizing that products are different, and it will subject the banking industry to a more rigorous test to qualify for the advanced techniques. While Mr. Gilbert believes in the fundamentals of the Basel initiative, he also noted some potential problems. First, operational risk and disclosure requirements remain a concern. Next, he noted the implementation challenges for both supervisors and banks. For banks, he discussed the challenges of trying to meet the qualifying criteria

for the IRB approach, including data capture and model input validation. For supervisors, Mr. Gilbert commented on the need to enhance resources to review bank readiness for implementation of Basel II.

During the Panel Two question and answer period, the Federal Reserve’s Mr. Rutledge addressed the concern raised by other panelists that the system created could lead to uncertain outcomes on the safe and sound operations of a bank. He defined the basic concept of the revised Basel rules and described the lengthy process of consultations and calibrations to ensure that the system works effectively.

### **Luncheon Keynote Address**

Ken Thompson, Chief Executive Officer of Wachovia, was the luncheon keynote speaker at the symposium. In his remarks, he stated that the three primary concepts of Basel II – robust risk management, strong partnerships between financial institutions and regulators, and transparency of information – could not be more appropriate in today’s environment. Mr. Thompson noted the greater importance of risk management by discussing Wachovia’s approaches to traditional and non-traditional risks. First, he said that credit risk management has become more complex. He discussed how Wachovia has taken a conservative approach on credit risk based on the risk adjusted return on capital. The second category of risk that Mr. Thompson discussed was the risk associated with a sizable merger. First Union and Wachovia merged almost one year ago, and to date Mr. Thompson reported that the bank was meeting or slightly exceeding its projected expense efficiencies for the year. One of the ways that the banks accomplished this feat was “to build risk management from the ground up.” The firm linked and coordinated the market, compliance, credit, and operational risks. Next, Mr. Thompson discussed reputation risk which he believes is one of the largest risks that banks face today. He noted that much of the goodwill that companies built over decades has been eliminated due to companies’ violation of trust of the American public. Mr. Thompson emphasized that adequate disclosures must become a best practice in corporate America.

### **Panel Three: The Rise of Risk Management: Challenges for Policymakers**

The third and final panel of the day highlighted challenges for policymakers. The first speaker, Peter Fisher, Under Secretary of the Treasury for Domestic Finance, focused his remarks on the absence of credit culture. Mr. Fisher noted that the rise in “macro-volatility” has resulted in the development of the science of risk management which has coincided with a corresponding decline in the attention to the basics of credit analysis. He suggested that the current status of risk management and credit management is a natural consequence of today’s marketplace. Mr. Fisher noted that in a financial environment with large swings, macroeconomic events can be relatively more important than the particular circumstances of an individual borrower. He indicated that the recent lack of appropriate credit analysis in the corporate sector has created problems for the U.S financial sector. In closing, Mr. Fisher stressed that the challenge for policymakers over the next five years would be to take the models, capital requirements, and Basel initiatives and use them as a starting point for recreating a credit culture focused on credit analysis.

The second speaker, Franklin Raines, Chairman and Chief Executive Officer of Fannie Mae focused his remarks on the current crisis in corporate governance. Mr. Raines reiterated the importance of restoring trust in American businesses by strengthening risk management and renewing confidence in public corporations. Mr. Raines views this era as a potential crisis period in corporate America, as capitalism and the selfish motives that underlie the system fall out of balance. He noted three problem areas that stand out: 1) compensation structures have fallen out of balance, 2) investors and managers have moved away from fundamentals, and 3) managers have denied responsibility for their actions. Mr. Raines noted that not only will new laws have to be enacted and enforced, but good corporate governance is essential to restore public confidence. He noted that Fannie Mae’s risk management practices are bolstered by seven major risk mitigants that may be helpful to other companies: 1) the continual onsite examination process of a financial regulator, 2) annual reviews by an independent external rating agency, 3) maintaining

a minimum capital level, 4) operating under a risk based capital approach, 5) maintaining liquid assets to meet unexpected demands, 6) strengthening market discipline by issuing market-priced subordinated debt, and 7) ensuring sound financial disclosures. In the end, Mr. Raines stressed that risk management and risk mitigation must continue to be strengthened to restore public confidence in corporate America.



Mr. Raines discussed Fannie Mae's risk management practices and the importance of sound risk management procedures.

The next speaker, Elizabeth McCaul, serves as the Superintendent of Banks with the State Banking Department of New York. Ms. McCaul believes that as regulators, “we have to share with our financial institutions some of the things that we’re seeing” in the areas of financial disclosure, financial transparency, and corporate governance. Ms. McCaul noted that as the financial services marketplace has evolved, financial institutions have become more sales driven and traditional client relationships have changed. She noted the lessons that were learned from banks’ losses in Long Term Capital Management where the importance of integrating market and credit risks were made clear. Ms. McCaul recognized the need “to build structures that get away

from the siloing of risk analysis” and to integrate this analysis into the new financial services marketplace. In conclusion, Ms. McCaul articulated the importance of ethical decisions in the workplace and strong mentoring relationships as part of a training program to ensure that the best decisions are being made.

The final speaker was Randall Kroszner, who served on the President’s Council of Economic Advisors. Mr. Kroszner reaffirmed the important role of trust in the marketplace and the private market’s response to the issues of risk and corporate governance. He stated that striking the appropriate balance between government and market regulation is important, since government regulation will not work fully by itself. Ethics and individual behavior remain integral to the efficient functioning of the marketplace. Mr. Kroszner detailed President Bush’s actions to strengthen regulation, the steps taken by the SEC to hold corporate wrongdoers accountable, and the attempt of Basel II to better harness market forces. He believes that flexibility, innovation, and public disclosure are elements of a sound financial system. Mr. Kroszner stated that companies would seek to operate in appropriately regulated markets because of the confidence and trust that result. He added that third parties, such as rating agencies, also offer risk assessments of industries to promote corporate governance. Mr. Kroszner articulated that the meshing of public and private regulation is critical to ensure appropriate oversight responsibilities. A “one-size fits all” approach to regulation does not work well, and he stated that the new Basel Accord addresses this issue.

Following the presentations, panelists responded to audience questions. The first question posed was if the panelists ever wished for a different disclosure regime. Mr. Fisher responded that he would like to see median high-low corporate data instead of snapshot quarterly or annual data. Mr. Raines echoed the same sentiment by stating that active disclosures and separate risk tracking are critical to sound markets. Conversely, Mr. Kroszner challenged market participants and analysts to use the disclosures that are already available. Finally, Ms. McCaul stated that the true transparency of financial statements across industries must continue to be an area of focus in the future.

The second question inquired whether the benefits that Fannie Mae enjoys through its concentration of

knowledge in the mortgage industry are outweighed by the risks associated with limited diversification. Mr. Raines responded that Fannie Mae’s returns have been very predictable and that the theory of diversification across product lines is yet unproven. The final question was addressed to Mr. Fisher inquiring whether outsourced credit analysis should be more effective or is there a market failure that prevents credit analysis outsourcing. Mr. Fisher responded that are efficiencies in outsourced analysis; however, additional scrutiny must be given in situations where greater credit risk is undertaken in an attempt to beat an industry benchmark or index. Mr. Raines responded that outsourcing credit judgment is very ineffective. He added “we have to have our own view of credit if we’re putting up our capital.”

[Symposium Agenda](#)  
[Speakers' Biographies](#)

**About the Author**

Mary Garner is a Senior Financial Analyst in the Financial Institutions Section of the Division of Insurance and Research.