Opening Remarks

Chester B. Feldberg

On behalf of the Federal Reserve Bank of New York, I would like to welcome all of you to New York City and to our conference "Financial Services at the Crossroads: Capital Regulation in the Twenty-First Century." Today's large and distinguished audience reflects our good fortune in deciding early last year to hold a conference on this particular topic at this particular time. We have more than 250 registered participants as well as many observers from throughout the Federal Reserve System. Among those attending today are fifteen members of the Basle Committee on Banking Supervision, virtually all members of the Capital Subgroup of the Basle Committee, several senior U.S. financial supervisors, and representatives of financial institutions from more than fifteen countries. The academic community is also well represented.

Although we at the New York Fed are the hosts of this conference, the conference has been organized in close collaboration with the Bank of England, the Bank of Japan, and our colleagues at the Board of Governors of the Federal Reserve System. It is a sure sign of how truly global our financial system has become that the very first step we took in planning today's conference was to enlist the active participation of those institutions. I would like to thank the individuals from those institutions who helped arrange the conference—Patricia Jackson of the Bank of England, Masatoshi Okawa of the Bank of Japan, and Allen Frankel of the Board of Governors—as well as the team here in New York, led by Bev Hirtle, for their outstanding work.

It was just about a year ago that we began planning the conference. At that time, we were deeply engaged in several capital-related activities: the completion and implementation of the Market Risk Amendment to the Basle Accord, a Federal Reserve study of credit risk modeling, the development of a supervisory approach to credit derivatives, and the assessment of a new round of securitization activity. All of these efforts suggested that it was an appropriate time to hold a forum on capital regulation.

Further stimulus was provided by developments in the research and financial communities. We were seeing new techniques of risk management—techniques that relied on innovations in analytical and statistical approaches to measuring risk. We were also seeing an increasing integration of traditional banking functions, such as commercial lending and interest rate risk management, with the full range of capital markets activities. Finally, we could not ignore the widening gap between the sophisticated risk management practices of financial institutions and the

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simpler approach to credit risk capital requirements embodied in our current capital standards.

It is important to remember that the original Basle Accord incorporated what was, in the mid-to-late 1980s, state-of-the-art assessment of capital adequacy at large financial institutions. Partly for this reason, the Basle Accord was, and still is, viewed as a landmark achievement of the Basle Committee and a milestone in the history of banking supervision.

The adoption of the Accord was quickly followed by a critique of everything from the original risk-weighting scheme to the handling of derivatives-related credit exposures. The Basle Committee has responded by amending the Accord several times to update it and to incorporate the new capital standards for market risks—standards that were seen as necessary even at the time the Accord was first published. Thus, more than most international agreements, the Accord is truly a living document that has continued to evolve with advancing financial industry practices.

Evolution is almost too soft a word to describe the changes we have witnessed in the financial sector over the decade since publication of the Accord. Innovation in this sector seems to come in bursts. Consider, for example, the development of derivatives in the early 1980s and the growth of option-related instruments in the late 1980s. And in the late 1990s, innovation in credit risk management appears to be reaching high gear. Indeed, in the relatively brief period since we announced this conference last spring, we have seen the launch of credit-modeling packages by major financial market participants; new uses for credit derivatives and credit models in the securitization of commercial credit; and, for supervisors, a sure sign that an innovation has arrived—the first problems relating to Asian credit derivatives.

Credit risk is without question the most important risk for banks, but not just for banks. I suspect that when one tallies the losses racked up in the securities, insurance, asset management, and finance company industries, no small measure of the total losses can be attributed to credit risk in some form. Therefore, how we adapt our supervisory approaches and our capital requirements to credit-risk-related innovation has high stakes both for financial institutions generally and for the global supervisory community.

Credit risk, however, is not the only important front on which change has been extraordinarily rapid. The pace of convergence among the banking, securities, and insurance industries and their various product offerings is accelerating. For that reason, we have entitled this conference "Financial Services at the Crossroads" rather than "Banking at the Crossroads."

As the number of true financial conglomerates steadily increases and the risks faced by the different industries within the financial sector become more alike, we in the supervisory community are increasing our dialogue on such issues as corporate governance, risk management, and capital adequacy, especially through organizations such as the Joint Forum. One result of this dialogue is a growing recognition of the value of choosing regulatory approaches that can accommodate a wide range of financial firms and activities. In addition, we are working to unify our vocabulary and to reach a shared understanding of key risk concepts and practices. Certainly, a foundation of common risk concepts and practices would contribute significantly to greater transparency within the financial sector.

These are broad issues. But for this conference to achieve its full purpose, it must take a broad perspective. One benefit of an academic-style conference, with a call for papers and a long lead time for paper preparation, is the ability to search the horizon for as many creative ideas as possible.

Given our intention to represent a wide range of thought on capital regulation, it may surprise you to see that half of the conference sessions with prepared papers deal with risk modeling. I conclude from the prevalence of this topic among the papers submitted to us that the financial community, including the supervisory community, has moved resolutely and irrevocably to incorporate sophisticated financial techniques into its thinking about capital, risk management, and financial condition. Nevertheless, as

I believe you will see throughout the program, risk modeling is itself a mansion with many, many rooms, which we and the financial community have just begun to explore. Therefore, in searching for approaches to twenty-first-century capital standards, we should not stop at the very first room. Moreover, the growing industry reliance on risk modeling itself raises many questions about how supervisors should make use of information from risk models and the extent to which we should accept a financial institution's own assessment of its capital adequacy, whether assessed through models or other means. Several papers in the second half of the program will discuss these issues.

Our hope is that this conference can accelerate the development of a consensus between the public and private sectors on an agenda for twenty-first-century capital regulation. My special focus is on the work of the Basle Committee, of which I am pleased to be a member, since the Committee has played and continues to play a leadership role in the development of capital standards for the industry.

I am very aware that the process of developing supervisory policy at the international level will take considerable time. We need time to educate ourselves about the impact of our current capital standards and to examine how those standards are affected by new developments, especially innovations in credit risk management. We need time to study the possible responses to such developments and the full ramifications of the responses. We need time to choose carefully among the various options available. And we need time to plan for implementation and transition. The need for such a long period of preparation suggests strongly to me that now is the right moment to devote the better part of two intensive days to a conference on twenty-first-century capital standards.

Once again, I am delighted to welcome you to the Federal Reserve Bank of New York. I am confident that you will find the conference both provocative and productive.