

Risk Management: One Institution's Experience

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I am very pleased to be part of this forward-looking conference on developments in capital regulation. Because the purpose of capital is to support risk, I decided to approach this session from the viewpoint of someone leading an institution that depends, for its success or failure, on how well it manages risk. My plan is to take you through my experiences at Chase Manhattan Corporation and to close with some thoughts on the implications of these experiences for capital regulation in the twenty-first century.

What I am going to describe to you is a dynamic approach to risk management, though not a perfect one. We continually make improvements, and we need to. Nevertheless, if I look back on the last six months—and the Asian crisis that has dominated this period—I would argue that never during this time did I feel that we had failed to understand the risks we were facing. In addition, I feel fairly confident that our regulators have a reasonably good understanding of the systems we use, and that, in the event of a crisis, these regulators would have access to daily information if they needed it.

Let me speak for a minute about market risk. There has been considerable discussion at this conference

about the limitations of the value-at-risk approach to risk measurement. This approach is, of course, imperfect: it is built on the same kinds of assumptions that we all use routinely in our work.

In my view, value at risk is important, but it cannot stand alone. At Chase, we calculate our exposure to market risk by using both a value-at-risk system and a stress-test system. These systems apply to both the market-to-market portfolio and the accrual portfolios. We use this combination of approaches to set limits on the risks we undertake and to assign capital to cover our exposures.

We came into 1997 with five stress-test scenarios built into our systems: the October 1987 stock market crash, the 1992 exchange rate mechanism crisis, the March 1994 bond market sell-off, the December 1994 peso crisis, and a hypothetical flight-to-quality scenario. We are currently expanding this set of scenarios to include four new prospective scenarios. In developing at least three of these four, we will have to use our judgment to predict how currencies, interest rates, and markets would be affected. By contrast, in the case of four of the five scenarios now in use, we already know the outcome.

Our risk limits in 1997, and certainly into early 1998, have been set by assessing our risks against these stress scenarios and the value-at-risk system. In fact, in the last year, the balance between the two approaches to risk

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management has probably moved more to the center. In any case, this combination of approaches has enabled us to manage market risk successfully.

Now, turning briefly to credit risk, let me review how our institution handles it. First, at Chase, we monitor individual transactions from several angles. We examine not only how the transaction is structured but also how it measures up against our lending standards. In this regard, an independent risk-rating process for applying and verifying risk ratings—one that is entirely independent of the units that actually carry out the bank's business—is an essential part of the credit review process at Chase. We also decide, at the time of the transaction, which credits we plan to hold in our portfolio and which we plan to sell into the market. Finally, we determine the contribution that each transaction makes to the overall risk of the portfolio because that contribution forms the basis of the capital allocation process.

Second, we identify and control credit risk by looking carefully at portfolio concentrations. Many of the crises of the 1980s—the real estate crisis, the savings and loan failures, the debt buildup in developing countries—can be traced to a failure to monitor portfolio concentrations. Recognizing these concentrations—for instance, by industry or by country—is a key element of understanding the true risks of the credit portfolio.

Institutions should track these concentrations as part of a dynamic approach to managing their portfolios. Dynamic portfolio management involves changing exposures to various risk categories through securitization, sell-downs, syndication, and other means, while continuing to serve your good clients.

At Chase, such dynamic management of concentrations in the portfolio is an important aspect of our overall risk management strategy. We've found that it brings results: for instance, because of our attention to portfolio concentrations, Chase did not have finance company risk in Korea in 1997. That was not an accident.

Third, we control risk by applying stress testing to our credit portfolio. Although the stress tests are not perfect, they do provide important guidance. For example, in the early stages of the Asian crisis, we ran a simulation

in which we took the Asian segment of our portfolio and lowered the ratings of every credit by two grades. Then, by using historical data on nonperforming credits and charge-offs, we estimated how much of our Asian portfolio, in a two-grade drop, would be identified as nonperforming and how much would be charged off. Again, although the stress-testing approach has its limits, it was helpful in assessing our institutional risks.

A fourth way in which we manage credit risk is to review our customers on a real-time basis. It is especially important in an environment of crisis—such as the current financial turmoil in Asia—to look at every customer carefully. In this way, we have an evolving customer-by-customer view of our risk exposures, as well as an evolving stress-test view of our risks.

Moving on, let's consider how institutions can manage operating risks. Anyone who has been in this business as long as I have—and it is probably longer than you imagine—knows that payments system operating risks are crucial. Institutions must pay attention to the condition of their counterparties and to changes in the patterns of clearing activity. They should also regularly review the suitability of their intraday bilateral limits. In this regard, I would argue that the world's clearing systems and, most important, the New York Clearing House and the Clearing House Interbank Payments System [CHIPS] have worked with incredible efficiency and effectiveness to manage the operating risks that have arisen during the last six months.

Now, let's turn our attention to management oversight. Considerable responsibility for the sound operation of an institution rests with the management. Having a range of risk-monitoring systems is important, but if the findings of these systems are not relayed to management, then the systems will be of limited use. At Chase, market risk information is made available daily—not only to the traders but also to managers at the highest levels—the business manager, the head of capital markets, Walter Shipley (chairman and chief executive officer of Chase), and me. These daily reports are used to assess current risk control strategies and to develop an appropriate limit structure for the institution.

Similarly, information relating to credit risk goes to the business manager, to the head of the global division, to the corporate credit policy division, and to Walter and me. Information bearing on operating risk and payments system risk is reviewed by the payments system manager, the head of Chase Technology Services, the head of credit for institutional clients, and Walter and me.

In addition to reviewing the risk estimates provided by the business units, the senior officers of an institution also need an independent risk management unit. At Chase, this group runs the models and the management information systems, tests the models, works on the theory underlying the models, and gives us an entirely independent view of what we are doing every day.

As part of our approach to risk control, Walter and I routinely begin the week with two meetings: one is to review market risk, and the other is to assess credit and underwriting risk as well as current developments. Because of the events in Asia in recent months, we have held these meetings even more frequently—in fact, on a daily basis during some periods. In addition, each night we have reports on every market risk item on our desks.

The careful identification and analysis of risk are, however, only useful insofar as they lead to a capital allocation system that recognizes different degrees of risk and includes all elements of risk. At Chase, each business is allocated capital on the basis of the different types of risk it assumes—market risk, credit risk, and operating risk—and for the good will and other intangible assets it creates. Finally, we have added to these capital allocations a balance sheet tax for assets and for stand-by letters of credit—two measures that have not proved entirely popular.

The rationale for our procedures is that once we have characterized our risks, we want to make sure that we have allocated capital in accordance with these risks. In addition, we want to make sure that the returns we get from our businesses are commensurate with the risks we are actually taking.

What are the implications of our experience for regulators? First, it would be unwise to develop regulations that place inflexible restrictions on detailed aspects of our businesses. Banking is a very dynamic business, and regu-

lation must be flexible enough to fit the institutions that are being examined.

Second, regulators should be very comfortable with the risk models used by each bank. In evaluating an internal model, regulators should adopt four criteria: Does the model closely mirror the markets? Is the complexity of the model (or of the combination of models used by the bank) commensurate with the institution's business and level of complexity? Does the model truly differentiate among various degrees of risk? Can the model be adapted to accommodate new products and new business, and, if so, is the review process for new products and services a sound one?

Third, regulators should examine an institution's capital allocation system for how closely it mimics markets and how well it differentiates risk.

If regulators follow these suggestions, then it should be easy to determine whether institutions are successfully managing their exposures or exceeding their risk limits. It should also be easy to check the returns on the risk-adjusted capital applied.

In closing, I would like to return for a moment to a theme raised in the conference's keynote address. Alan Greenspan remarked that our major banks use the probability of insolvency as the measure of institutional soundness for their internal risk assessments. It might be helpful, then, to identify some early warning signals of insolvency. In this connection, I recommend that supervisors monitor more carefully the level of subordinated debt issued by banks. Under what market conditions is the debt issued? How is the debt priced? How does the market react to the issue? How does the issue subsequently trade? At Chase, we are already attempting to implement this kind of review with our clients.

Another early warning signal might become available with the adoption of private-sector deposit insurance. I have thought long and hard about this issue over the years and can make a good case for private-sector deposit insurance. I would argue that if an institution were to buy commercially the first 5 percent of its insurance coverage on deposits (in the United States, this would mean that the Federal Deposit Insurance Corporation would be

responsible for the remaining 95 percent), observers could learn a great deal about the soundness of that institution from the pricing of the insurance.

What I have given you today is the view of a practitioner, one who seeks to identify and control risks that could undermine the first-class institution he manages. My experience suggests that regulators should seek dynamic, rather than static, solutions to the problems of

risk management and capital adequacy—solutions that reflect the diversity of the regulated institutions and the rapid changes in the structure, products, and risk control practices of the financial industry. If regulators look carefully at the risks assumed by each institution and the models each institution uses to calculate its exposure, then I am confident that they can determine the right capital positions.

Thank you all very much.

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