Welcome Remarks
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Auditorium

Welcome to our Joint Conference on Capital Allocation for Operational Risk, sponsored by the Federal Reserve Bank of Boston and the Board of Governors of the Federal Reserve System. Let me begin by thanking all of you for attending the conference, and extending a special thanks to Roger Cole and his staff at the BOG for jointly sponsoring this conference.

The events of September 11th have had an understandable impact on people's decisions to travel to and attend a conference such as this. As you know, many other conferences scheduled for this fall have been cancelled or deferred. While the planning of this conference, like so many aspects of our lives, was affected by those tragic events, the dedication of the presenters and attendees to this topic allowed us to keep the conference on track, and maintain its high caliber. Again, I want to thank each of you for being here and helping us put together such a strong program.

The topic of operational risk has never been more relevant than it is today. This conference should be a timely and very important vehicle for sharing ideas and experiences that can further our understanding of operational risk. As you look at the agenda, you will see that we have put together a program with representatives from the entire spectrum of the financial services industry, including its regulators and leading academics in the field of risk management. This reflects a shared view that the question of how to best manage and measure operational risk will be answered most effectively with input and insights from an interdisciplinary exchange of ideas. Actually, it's my own bias that the experienced practioners and regulators amongst us should lead the way, but the evolving academic work needs to inform us as well.

We meet at a period of time likely not envisioned by those who began the Basel II process a few years ago. It is a time of global downturn, perhaps a global recession as those things are measured. It is also a time during which financial systems have not everywhere shown themselves to be resilient. But here in the U.S. and elsewhere, economic health is benefiting from strongly capitalized financial institutions, unlike periods in the eighties and early nineties. This is not simply a matter of good fortune. The focus of financial institutions and their regulators on risk weighted capital ratios, and on a continual evolution in the sophistication of risk management techniques has undoubtedly played a role. It hasn't been perfect -- even Nobel Laureates have been led astray -- but I believe it has been critical to the relative health of many institutions -- in the U.S. and elsewhere -- as we enter this challenging period.

We also meet at a time no one would have ever envisioned -- the aftermath of September 11. Here I believe there is strong evidence that risk management, in particular operational risk management, played a critical role in the U.S. financial system's resilience, and in the ability of the global system to cope as well. But September 11 and the days afterward also reflected the many ways in which the system both domestically and globally must be improved and made even more resilient. That crisis, like others much less tragic in nature, revealed the cracks in many institutions' assumptions, the single points of failure, the infrastructure weaknesses that must be addressed both individually and collectively if the overall system is to evolve to meet the challenges of the future successfully.

In that regard, it seems to me fortunate that the Basel Committee on Banking Supervision, as part of the proposed new Capital Accord, dealt explicitly with the issue of operational risk. While the proposal has generated controversy, it was a critical step in furthering the process of fashioning an appropriate framework for dealing with this important area.

In response to the January proposal and the more recent Working Paper on operational risk, staff here at the Federal Reserve Bank of Boston together with other Federal Reserve colleagues have been engaged in detailed analysis relating to operational risk. This work has contributed to our evolving views on the appropriate framework for quantifying operational risk, and has reinforced my thinking that certain core principles should be at the center of any capital allocation framework for managing operational risk.

First, I believe an operational risk framework should be tailored to reflect the idiosyncratic business mix and operational risk management practices of individual firms. This principle reflects the simple fact that operational risk varies by organization based on the nature of the firm's businesses operations, technology, risk appetite, and risk management and controls.

Second, and possibly most important, any framework should meet the critical objective of providing incentives for organizations to invest in the technology, infrastructure, and controls that reduce operational risk. To achieve this objective, the framework must reward, and should not be indifferent to or penalize banks that invest to reduce their operational risk. By creating the proper incentives, banking supervisors will align their goals with those of financial institutions and reinforce the movement toward prudent management of operational risk.

A third core principle I believe should be part of the capital allocation framework is appropriate recognition of the use of risk mitigation techniques such as insurance. Insurance has been a longstanding and effective operational risk mitigant for financial services industries, and it and other evolving techniques should be encouraged as part of the solution to managing and mitigating operational risk.

Given the idiosyncratic nature of operational risk, there is understandable difficulty in crafting a detailed regulatory regime that is risk-focused, provides appropriate incentives to invest in managing operational risk, and encourages flexibility and innovation in the area of risk mitigation. To achieve these objectives, policymakers are considering an approach that allows banks to rely heavily on internally generated capital allocation models. Unfortunately, many of these modeling techniques are in their infancy. This poses challenges to the financial institutions developing them, and to the supervisors who would have to approve their use. I think this conference can be an important first step in identifying and overcoming those challenges, as I am confident that the information sharing and the interaction between leading experts in the field will prove to be valuable to all.

I look forward to a productive day and a half. My thanks again for your attendance and participation in this forum. Together we should make this an informative and enjoyable conference.