**Remarks by**
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**before a**
**Symposium on Credit Derivatives**
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In recent years, there have been questions about the value of bank supervision and regulation. Given our current, extraordinarily stable economic environment -- and the tremendous profits that banks have been able to make as a result -- this criticism should come as no surprise -- memories can be short in good times. Because a high tide lifts all ships, strong and effective supervision and regulation may appear to some people as less necessary in good times. When the tide runs out and economic strains reveal the weaknesses at institutions, however, no one questions the utility of banking supervision and regulation -- in fact, quite often, there are calls for more.

Banking supervision and regulation seek to impose on bankers a discipline that common sense would otherwise require. Most bankers have common sense, and so the advocates of less regulation argue that supervision is unneeded. The target of supervision is not the bankers with common sense, however, it is the bankers who fail to demonstrate common sense.

That principle is not new. Franklin Roosevelt noted in a radio address in 1933 that "the acts of a comparative few [bankers] had tainted them all" in the banking crisis that led to the creation of the FDIC -- a crisis illustrated in the period photographs hanging on the walls of this room. Bank supervision and regulation seek to maintain stability in the marketplace by preventing or isolating the acts of a comparative few from tainting others. Certainly, there is a price for that stability -- but these photographs remind us that there is a larger price for instability.

This symposium offers us an opportunity to examine the value of banking regulation as it affects credit derivatives and affords participants the opportunity to shape the analysis that will guide their future regulation.

Last year the FDIC hosted a symposium here on the capital markets. In January, we hosted a symposium on the lessons from the most recent banking crisis. We sought to learn from the past so that we could work toward a better future. Both symposia reflect the FDIC's commitment to the process of risk assessment -- to moving ahead of the curve in the markets -- so that we can stay on top of developments. Our goal in risk assessment is to be able to address problems before they threaten the safety and soundness of individual institutions, as well as cause losses to the insurance funds.

That commitment also resulted in our creating a Division of Insurance, which identifies, monitors, and assesses risks in the financial system and the economy to provide economic and financial data to our examiners, as well as early warnings to bankers of negative trends in the industry and the economy. That commitment has led us to a systematic analysis of the causes of the 1,617 bank failures and assistance transactions from 1980 through 1994, which establishes a base-line reference both for research and for risk assessment that will help us to identify trends that could affect the future health of the deposit insurance funds. Given the explosive growth in credit derivatives in recent years, I thought that we should follow up with a symposium focusing more particularly on this new product.

Financial derivatives generally facilitate the intermediation of market risk, which has been extensively quantified and, therefore, is open to sophisticated analysis. Credit derivatives, however, permit the unbundling and intermediation of credit risk, which has traditionally been managed, loan-by-loan, by bankers using their judgment to apply underwriting standards. A great deal of banking regulation and supervision, especially in modern times, has dealt with the adequacy of an institution's underwriting standards. It is judgment in applying underwriting standards that ostensibly separates bankers from the remainder of humanity.

In applying credit judgment, however, bankers have a less-than-perfect record. As we found with Penn Square and Continental Illinois in the early 1980s, even with far less complex arrangements than derivatives represent, poor credit judgment can lead to disastrous losses. Moreover, in systematically analyzing the failure of 1,617 institutions in the banking crisis of the 1980s and early 1990s, we found that banks generally failed the old fashioned way -- by making bad loans. That was as true for larger banks as it was for smaller ones. Ultimately, these failures depleted the FDIC insurance fund.

Because credit risk lies at the heart of credit derivatives, the bank regulator and deposit insurer must view them, first and foremost, as loans and pieces of loans. As with any loan, the question is: "How solid is the credit judgment backing up this loan?" Every bank that holds a credit derivative, regardless of who originated it, should know the answer to the question. In this period of infancy, most credit derivative contracts have been concentrated among the better credits, but if the market is to expand, they will be extended to lower-rated credits, which adds to the importance of understanding that a credit judgment is being made.

The real issue is whether a credit derivative is different than other loans. To answer that question sensibly, regulators need to understand the purpose and function of credit derivatives in the real world context in which they are used. Our challenge is to identify the risks embedded in credit derivatives and establish appropriate standards for those risks -- including appropriate capital requirements under the Basle risk-based capital accord.

Credit derivatives have given rise to concerns at the federal bank regulatory agencies. To address some of those concerns, the agencies last August issued preliminary

guidance to examiners on how to treat credit derivatives during examinations, including a framework for analyzing the risks incurred by insured financial institutions that use them. The guidance stresses that banks should have sound risk management policies and procedures, including adequate internal controls, in place for credit derivatives. The guidance also stresses that any bank engaged in credit derivatives, either as beneficiary or as guarantor, must perform an analysis of the credit risk involved in the instrument. We noted in August, however, that bank regulators in the U.S. and in other countries were continuing to analyze the new instruments and our discussions could result in revised or additional supervisory guidance. In addition, a few institutions affected by the guidance have raised questions about it. This symposium is intended to help the FDIC understand the effect of the preliminary guidance on the market for these instruments, as well as to gather facts that will help us learn more about what credit derivatives are and what they do for purposes of developing more definitive guidance.

We have assembled a wide range of participants here today to discuss the emergence of the market for credit derivatives; the economic forces shaping that market; and the regulatory, legal, and accounting issues that are relevant to the market. I want to welcome you this morning and to thank you for contributing your time and expertise to this important effort. I am sure there will be a stimulating exchange of ideas from every one on the dais and in the audience. This discussion will lead us to formulate an approach that makes the most sense in connection with the real world evolution of the credit derivatives market.

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