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Are We Wasting a Good Crisis?
Leading Risk Managers Give Their Views

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It's a fair question, and many investors, taxpayers and financial professionals are asking whether regulations conceived in the quest for post-GFC reform really will help make the global financial system more stable. Some even wonder whether some, poorly thought-through regulation may actually make it more fragile.

In Crisis Wasted? Leading Risk Managers on Risk Culture, we ask ten global risk management leaders what they think and why. Their conversations yield some surprising insights into the practicalities of managing risk in large financial organisations, shedding light on questions such as: Why would a talented person want to be a risk manager? What do you do with all those risk statistics? What are the real pros and cons of internal versus standard models for calculating banks' capital requirements? And, Will some provisions in Basel III make the system more fragile?

Spurred on by bank failures and government rescues in the northern hemisphere, policy makers have proposed new capital measures, identified new risks with derivatives and collateral markets, imposed more conservative balance sheet treatments for "special investment vehicles", and made efforts to align remuneration with outcomes, with renewed emphasis on the organisation's culture necessary to support risk-taking activities. But so far nothing that aims to encourage more cautious behaviour.

In a new book, Crisis Wasted? Leading Risk Managers on Risk Culture , ten senior risk managers in global financial organisations explain what they believe to be the most pressing issues affecting systemic stability, how well they are being addressed, and how much might be window-dressing. Of two dozen or so issues raised in the course of conversations, we give a digest of four, starting with why a talented individual would choose to be a risk manager.

1. Good risk management is more than a corner office

Following the global financial crisis, financial organisations are expected to demonstrate strong risk management, which of course is good news for investors and tax-payers. Organisations have responded by elevating the status of their Chief Risk Officers (CRO). But good risk management may not be as straight-forward as it may seem, for at least four reasons.

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The first is that risk managers do not receive the same market signals that traders do – and the information they do have is usually delayed and only in summary form. They are thus on less than equal footing when they need to challenge risky positions.

Second, the risk managers' job is complex: risk managers need to know the traders' jobs as well as their own. On top of that they need more than a dose of lateral and forward-thinking as well as excellent communication and persuasion skills, to ensure that the right actions are taken at the right times.

The job is also more risky than the trader's. When things go well, the risk manager earns a salary and bonus that often pales beside those of traders, especially when you compare the range of skills needed for the two roles. When things go badly, even if as a result of having been overruled, the risk manager can both lose his or her job and suffer damage to his or her professional reputation.

Another problem is that, with demands for ever more regulatory risk reports, risk management is increasingly confounded with, and dominated by, risk reporting, shifting the focus away from common-sense and intuition toward a mechanical process that is prone to missing unexpected but important risk signals.

> "If I were doing risk management today, I would never run the official corporate risk function because your whole life is regulatory reporting. These days, in the official function you spend your life running a post office." John Breit

Risk managers say that the best part of the job is its intellectual challenge, yet even this appeal is under threat, which will deter many of the most talented individuals from the job.

And anyway, what do you do with all those risk statistics?

2. Irrational exuberance for risk statistics

A natural response to the apparent failure of risk management is to demand more information about risk exposures. Certainly, organisations that enjoy explicit or implicit public guarantees, or whose failure would threaten the stability of the financial system, should be obliged to report on the risks they assume. But simply demanding ever-more detailed risk reports can do more harm than good.

To begin with, as with any kind of regulation, demands for more detailed risk reports come with costs and unintended effects.

One unintended effect is that regulators often have neither the background skills nor the resources to make practical sense of its volume and complexity.

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The corrosive effect of this is the false sense of security conveyed to investors and consumers, who assume, reasonably but often erroneously, that risk is being monitored effectively and systemic stability supported.

The most obvious cost of more reporting is to firms, of gathering the information, which is inevitably passed on to customers. Some firms find themselves devoting so much resource to risk reporting that real risk management suffers.

> *"Increasingly, institutions are managing to regulations and not to their risk." Richard Meddings*

More damaging is that this cost is largely fixed, favouring large organisations and impeding the emergence of new, innovative firms that are most likely to challenge the dominance of giant banks and offer choice to consumers. So if an aim of financial regulation is to contain the systemic risk of banks that are "too big to fail", then demanding ever-more reporting aggravates that problem.

> *"It is far from clear to me that the system is safer for all the regulation. It has created a barrier to entry for smaller start-ups. That may be good for some incumbents but not for business formation." Sir Michael Hintze*

Rather than stabilising the system, it diverts resources away from risk management, encourages ever more concentration of market power in large firms, reduces diversity between firms and makes the system a bit more fragile.

Then there is the question of measuring risk, and the pros and cons of internal versus standard models for calculating banks' capital requirements.

3. Sibling rivalry among risk models

An important innovation of Basel II was that banks should use their own, internal models to estimate the amount of capital they should hold. The reasoning was that banks understand their investments better than any outsider, so the models they build themselves are, a priori, best able to capture their risk. Regulators demanded only that the same models be used to estimate capital requirements and to manage the portfolios themselves, known as the "use test". This works so long as banks are subject to continuous scrutiny by creditors and investors, who ensure that risk is maintained at the level that keeps borrowing costs low. But the use test may not always work in practice as well as it should.

One reason is that, with the general level of interest rates at historic lows, borrowing costs are very low, even for quite risky borrowers. Another is that different banks' models give very different estimates of capital requirements – even for identical

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portfolios of assets. There are of course arguments that banks may have good reasons to allocate different amounts of capital to similar portfolios. For example one bank may choose to combine very active risk management with less reliance on capital buffers, while another may complement a summary level of risk monitoring with a strong capital cushion.

> *"There are perfectly good reasons why banks have different appetites for risk, which make the risk weights attributed to apparently identical loans different. That is wholly appropriate." Richard Meddings*

Yet the widely drawn conclusion from this divergence is that banks had done what is, for them, rational: they had optimised their models to flatter their own books in order to keep capital requirements to a minimum, regardless of what the real risk might be.

> *"Arguments are even being made that banks should be allowed to regulate themselves. Imagine." Adrian Blundell-Wignall*

The alternative to using banks' internal models is to impose a uniform, standard model on all regulated organisations. This may improve comparability, but there are drawbacks:

- One size fits nobody: a model built for some "average" or "typical" portfolio may be ill-suited to actual portfolios, with the result that some risk may be mis-estimated, or missed altogether, and capital requirements understated.
- Models imposed by even the most astute regulator will be slower to adapt to changing market conditions and portfolio profiles than models developed by the organisations themselves, so some sources of risk can remain un-measured.
- Any modelling errors in the standard model will be amplified across all large organisations, which could cause the system itself to become under-capitalised.
- The incidence of crowded trades, where many investors buy and sell similar assets at the same time, is greatly increased when all financial organisations are compelled to use the same model.
- A single model cannot take account of banks' different approaches to risk management.

By proposing to combine, in tandem, internal and standard models, Basel III seeks to preserve the benefits of both. Internally developed models would thus be harnessed as reasonableness checks on the standard model – and vice-versa.

But the danger is that, since maintaining and operating models is largely a fixed cost, and since creditors and investors will instinctively focus on what the standard model says, organisations will find it increasingly difficult to justify the cost of their internal models. Reasonableness checks and model diversity thus may in time be lost.

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And its not only about diversity of models: parts of Basel III may be making the financial system itself less diverse, more pro-cyclical - and more fragile.

4. Financial systemic monoculture

One reason why the 2008 meltdown wasn't worse than it was is because not everybody was selling at the same time. Long-term investors, such as pension funds, stepped in to buy cheap assets, critically breaking the fall in asset prices as banks, investment banks and hedge funds scrambled to raise cash.

The argument for maintaining the balance of buyers and sellers has never been stronger, yet two seemingly-benign provisions of the Basel III Fundamental Review of the Trading Book (FRTB), aimed at correcting some shortcomings in Basel II, may aggravate the problem of crowded trades and pro-cyclicality.

Plurality of investors and their different investment horizons are what keep the financial system from being even more unstable than it is. To see why, consider the different types of organisations that make up the financial system and the investments they hold. A given asset, say a bond, may be held by banks, investment banks, insurers, hedge funds, foundations, sovereign funds, family trusts, pension funds and mutual funds, as well as individuals.

Should the bond fall in value, investment banks and hedge funds may be obliged to sell it to meet margin calls on the short-term borrowing that financed its purchase. This puts downward pressure on the price, often triggering a pro-cyclical pattern of further sales and further price deterioration.

Mitigating this, long-term investors, such as mutual and pension funds, are under no pressure to sell. With no short-term financing demands to meet, they usually can ride out the short-term turmoil and may even take the opportunity of lower prices to invest more, reaping handsome long-term profits for their investors.

By standing in as buyers of under-priced assets, long-term investors provide crucial liquidity, a natural shock-absorber and counter-cyclical force in the financial system.

Enter the FRTB, which introduces a number of real improvements, including more clarity about what should and should not be in banks' trading books. But it threatens, in at least two ways, to unsettle the balance of buyers and sellers in times of market stress and to aggravate the chronic problem of pro-cyclicality.

The first is the apparently benign proposal to apply banks' internal risk models in tandem with a common, standard model to calculate regulatory capital requirements. In contrast to its laudable aim of preserving the benefits of both

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diverse and standard models, it may well, in time, help concentrate all risk measurement into a single, possibly flawed, model.

The second is to apply the same capital adequacy rules to all large financial organisations, including long-term investors, such as insurance companies, mutual and pension funds, as well as banks. This not only neutralises the shock-absorber effect that long-term investors now exert, but actually adds even more selling pressure at just the wrong time.

> *"Do you want to turn large pension funds into investment banks? No, but we may be heading, through regulation and accounting policies, to incentivise them to behave like banks." Todd Groome*

Corner offices for CROs, irrational exuberance for risk statistics, sibling rivalry between risk models and financial system monoculture. Financial system reform is not as simple as you perhaps thought. Crisis Wasted? Leading Risk Managers on Risk Culture gives plenty more reasons like these why some well-intentioned reforms conceal some nasty surprises.