Five Years after the Crisis: An Introspective Look at Risk Management

Thank you Mark for that introduction and to PRMIA and EY for inviting me to speak to this group this evening. Some of you have heard me refer to myself as a recovering CRO masquerading as an academic these days. Given my track record as a sort of accidental Forrest Gump of the banking business at some of the more notable institutions associated with the crisis, I suppose my remarks can be thought of in the context of lessons learned the hard way. In the years following my departure from my last CRO role at Citigroup, I have spent a lot of time teaching, writing and thinking about our profession, particularly with some distance now between us from those dark days of 2008. What I would like to do here is to take stock of where risk management has evolved over the last 5 years, with emphasis on three areas that will shape the direction of the profession going forward; namely risk governance, the effectiveness of regulation to facilitate prudent risk-taking behavior and building the talent base and infrastructure for sustainable risk management in the future.

No matter how much is invested in human capital, data, analytics and other risk infrastructure, a necessary and sufficient condition for effective risk management is a culture and governance process that cultivates a risk mindset that is pervasive throughout the organization. In other words, companies that are risk leaders have an intangible quality about them that cannot be forced upon them by regulation.

When people ask me what it was like to be a risk manager in the years preceding the crash, I tell them that it reminds me of a Super Bowl ad that appeared a few years back. In the ad, there were a number of monkeys sitting around a board room table with a party in full swing, monkeys were smoking cigars, burning money, having a great time since sales were going through the roof. The only human in the ad looks at the chart and tells them that sales are actually falling at which point the party immediately comes to a halt. Then the head monkey goes over and turns the
chart back the other direction at which point the party recommences. I tell people that my life as a risk manager was much like the human in that ad. So where does that leave us?

The nature of risk governance hinges on several significant factors:

- The support of risk management by senior executive management and the board
- The role of business management cognitive biases that affect risk-taking behavior, and
- Management perceptions of risk management and its stature within the organization

In a study I did a couple of years ago now for the Office of Financial Research, I sought to create a theoretical model describing the interaction between business and risk management taking these factors into account. Without a doubt, the “air cover” provided by the board and the CEO set the stage for what balance is struck between risk and business objectives. In my interviews with various bank boards, CEOs and CROs, those companies that appear to exhibit the “Right Stuff” from a risk management perspective are where the CEOs have hand chosen their CRO. In many cases these CROs had prior experience running a line of business, which brings a measure of business credibility that may not exist for CROs coming straight up the risk organization.

A virtual recipe for disaster is where a CRO is selected from outside the organization without a business background and faces off against a powerful and iconic CEO. Lacking a reference point to gauge the CRO’s balance between risk and business objectives, this face-off is particularly accentuated in a superheated market where tangible business metrics drive performance, stock price and of course compensation outcomes. In my study I lay out how a number of cognitive biases; in particular herd mentality, the house money effect and ambiguity bias by senior management drive risk-taking. In the heat of a pitched competitive battle among market participants, herd mentality can undermine objective, but uncertain risk views put forth by the CRO. Asymmetric information problems compound the effects of herd mentality as oftentimes it is nearly impossible to obtain insight into how competitors get comfortable with accepting higher risk that externally appears overly risky.

The House Money effect comes about by way of “priors” formed by management that are affected disproportionately by more recent outcomes. Kahneman also refers to this as the Illusion of Validity. The idea is that when times are good, management tends to rely more heavily on these outcomes to drive risk-taking and again coupled with a highly competitive market, these behaviors can significantly undercut views by risk management.

Rounding out this triumvirate of cognitive biases is ambiguity bias - and one I find risk managers have an uphill battle in dealing with particularly in an environment where the CRO has yet to “prove” themselves to executive management. Ambiguity bias refers to the behavior that individuals tend to favor decisions based on certain rather than uncertain outcomes. Risk management as we all know is among other things about depicting uncertain outcomes to management. Our reliance on such constructs as Value-at-Risk and other frameworks for
portraying probabilistic outcomes has become ubiquitous in our profession and yet they can also present a host of challenges in convincing management of abnormally risky strategies.

The intersection of all of the above biases together with a culture that rewards risk-taking creates an environment where the views of risk management may ring hollow as everyone is entitled to a view. Back in 2005, articulating that house prices might decline at some point in the future would be met with sharp criticism in such a toxic risk governance environment. Not only would this perspective be overruled, but also it would be one more piece of “evidence” by business management that risk management was truly the “Business Prevention Unit” a title actually used by senior management at one institution I worked for.

As destructive as such behavior toward risk management can be, I am of the opinion that regulatory agencies cannot force risk governance on an institution. The risk DNA is either there or not, and a danger in mandating Board Risk Committees, executive sessions and CRO responsibilities is that it introduces an artificial wedge between management and risk managers.

To be sure, these new rules certainly put pressure on firms to adopt strong risk practices, however, it is still up to senior management to determine the degree of integration of the risk organization with strategic business decisions and direction. My observation is that considerable movement has been made by the industry toward building a better risk management environment. However, I’m also reminded that our industry may be suffering a bit from the mentality where “there are no atheists in fox holes.” With the carnage left from the crisis and near death experiences of many firms still around, we may have gotten religion around risk management but is it short-lived is the real question.

I have the dubious distinction of starting my career off during the Thrift Crisis and ending it during the Financial Crisis. It reminds me that human beings tend to forget the pain from bad events with the passage of time. For that matter it is up to us as risk managers to keep these outcomes in front of management as well as to instill in our next generation of risk leaders a context for what I refer to as situational risk awareness. One of the appealing aspects of being a risk manager for me as someone that thrives on a diversity of challenges is the varied nature of risk management. The problem solved today is likely to look somewhat different tomorrow and for that reason, effective risk managers must be adaptable to changes in their surroundings and be aware of the potential for outcomes perhaps not observed in their experience. This leads me to discuss a critically important activity of risk managers; namely the development of our staff and profession.

Our profession has certainly evolved over time - increasingly looking more like an actuarial science than one driven by judgmental rules. And this comes for good reason; the complexity of financial transactions and scope of institutions’ activities has grown enormously in the last two decades, requiring greater analytic depth than we have ever seen. So it is no surprise that the risk professional associations highlight their various risk professional designations; the PRM for
PRMIA and FRM for GARP. But if you look at the curriculum behind these programs, you quickly find that the emphasis is on developing analytical skills with little focus on rounding out the sharp edges of pure risk analysts.

I am fond these days of telling my students that by taking my risk management courses that at best they are ready to become risk analysts but by no stretch can they consider themselves risk managers. The question I would pose to all of you is have we gone too far in flexing the analytical muscles of our staff at the expense of also stretching their right brain qualities. Again, my observation has been that for those of us that self-select into technical areas, there tends to be a bias we have toward overreliance on model outcomes. This occurs naturally for those engaged in model development and is one reason why the regulators have strengthened model validation guidance for financial institutions. But model outcomes can also present a host of challenges for management teams tasked with using this information to make decisions.

Recent trading losses of one of our largest banks had embedded in this incident a series of issues surrounding the accuracy and usage of VaR models. Instructing management of the strengths and weaknesses of such models is a risk management imperative and one that must be carefully thought out. Harkening back to ambiguity bias, pointing out model weaknesses can provide ammunition by some management teams to discount the results if they do not comport with their priors or with desired business outcomes.

For our profession, we need to introduce greater balance between the quantitative and qualitative aspects of risk management. Of particular interest should be the development of critical thinking. Simply being able to plug into a Gaussian Copula does not prove you understand the risk being measured. We saw with unfortunate consequences the effect of ignoring the dynamics of asset correlations despite the elegance and operational tractability such constructs provide. Hence we must somehow instill in our teams a healthy dose of skepticism. This is not to say that risk managers should be obstructionists in business decisions. What it does mean is that we operate on the principle that all models are wrong and that we carefully understand the inputs, data and assumptions going into these tools.

As a profession we can do more to promote better model awareness too. Our risk programs should be tailored to enhance data management skills. Oftentimes in my experience we were less likely to find risk modelers that also had strong data management skills. As a result, such a bifurcation in skills leads to inefficient staffing and potential disconnects between those building the models and those having a keen sense of data limitations feeding these tools.

Part of the problem in providing clear direction to staff in their development is that the profession and financial industry to some degree have not defined risk management all that clearly. At times, some companies have viewed risk management as a form of audit function, with responsibilities limited to performing oversight functions ensuring adherence with risk
policies and procedures. In this capacity, risk managers must possess good business and management skills to identify deviations from corporate risk requirements.

At other times, risk management has become inextricably linked with the business, at times blurring the objectivity of risk managers. Embedded risk management as well as corporate risk staff not only need good communications skills but also must have an ability to effectively negotiate. Risk managers must also develop a “world view” or Weltanschauung that transcends their parochial area of focus.

We all know that financial institutions exist to take prudent risk and that no firm could survive taking zero risk. Striking the right tone and balance in sometimes difficult management conversations is a highly prized asset in a risk manager. I’m reminded of a CRO colleague of mine that in a moment of frustration asked his CEO whether he wanted a lapdog or a watchdog. I would submit that the CEO should want neither, and that a blend of both is healthiest.

These qualities cannot be obtained from a risk certification program. So where does this leave us in professional development of our people? Continued emphasis on analytical approaches to risk management is a must given business complexity. However, we must do a better job of calling attention to the range of softer skills; negotiation, self-awareness, business acumen and communications that make a risk analyst a risk manager.

I’d like to turn now to the third area of focus for risk managers these days; namely regulation. Back in 2009 when I left Citigroup, I estimated that I was spending the better part of 80% of my workdays either meeting with regulators or answering their questions. From those risk colleagues still out there, regulation has become an expected staple of everyday life for a risk manager. One only has to look at Dodd-Frank, Basel III, and the CFPB to understand that regulatory risk has taken on a life of its own in the taxonomy of risks we face at financial institutions.

It is no surprise that one of the hefty prices paid by the crisis was unprecedented regulatory scrutiny. After all we see this as a natural response to crisis where the “regulatory dialectic” model first described by Ed Kane creates a tug of war between regulators and regulated. In benign periods regulatory oversight can lessen, allowing markets to expand further than they should. When they tumble, the regulatory response tends to tighten. We are living in that world today with no apparent end in sight. What does this mean for firms and risk management generally?

I’d like to talk about 4 distinct regulatory effects that we face these days:

- The unintended consequence of regulation
- Regulatory arbitrage
- Regulatory fatigue and
- Regulatory over-engineering
No doubt the financial crisis surfaced a number of deficiencies in the way financial institutions were managed and regulated before the crash. Some regulation was required to address these issues, but DFA looks to me to be as much a political response as it was a comprehensive and well-thought-out legislative response to the crisis. To illustrate this concern over unintended consequences consider the recently proposed rule on the Liquidity Coverage Ratio (LCR) by the interagency group of regulators.

LCR was a clear response to the liquidity crisis that ensued in 2008 that affected much of the industry during that time and had nearly catastrophic implications for the financial sector as a whole. Certainly there were lapses in the way institutions managed their liquidity buffers that exacerbated problems at the time. No question liquidity risk management should be strengthened from what it was in those days and conceptually I believe the LCR has merit. But in devising a three-tiered approach to establishing what constitutes High Quality Liquid Assets, the regulators may have placed one asset class and sector at some risk. Specifically, the treatment in the LCR of mortgage-backed securities may cause the prices of such assets to come under pressure as banks turn to other sources of liquidity to meet the 100% of short-term net cash outflows requirement.

The LCR places Fannie and Freddie MBS into the Level 2A bucket for High Quality Liquid Assets citing the lack of a federal guarantee on such securities. I guess we ought to inform the taxpayers who bailed out the GSEs of this view. Moreover, in the words of a pop song from a few years ago, “isn’t it ironic” that snapping up $85 billion in mortgage bonds a month is ok for the Fed but is subpar for meeting the HQLA definition.

Under LCR, GSE MBS are haircut 15% and the total of Level 2A and 2B assets together cannot comprise more than 40% of HQLAs. As a result, the regulatory authorities place further headwinds on a recovering housing market. On top of this, high quality private label securities are not counted in the LCR definition and derivatives activities put in place to hedge interest rate risk in mortgage pipelines as well as mortgage commitments are counted in the new outflows definition. While we may debate whether this is the right thing to do or not, it simply underscores the fact that regulation has consequences on assets and markets.

The second concern we should have with regulation deals with the potential for regulatory arbitrage. Some efforts have been made to engage in cross-border regulatory harmonization as we have seen with Basel as well as with various macroprudential regulations. Efforts to take various derivatives off OTC and onto exchanges in the US and elsewhere poses the risk of firms following a path of least resistance or in this case regulation and moving them to countries with less stringent regulation. Such moves may in fact be worse outcomes by reducing transparency and oversight of such transactions.

Another consequence of such regulation is the impact that it has on our ability to mitigate risks. While some market “oracles” contend that derivative instruments are financial weapons of mass
destruction, that statement clearly does not align with perspectives by those of us engaged in legitimate hedging strategies to mitigate interest rate, market and credit risk. Market-based risk transfer mechanisms are, as we know effective tools of the risk management trade. While there are many benefits from placing derivatives on exchange, great care must be taken in ensuring that placing too tight a noose around these products does not substantially worsen the availability, cost and flexibility of hedge instruments. At the same time I am reminded of the importance to assure markets, investors and regulators that such instruments have appropriate safeguards built in around their trading.

The third concern over regulation is the potential it creates for regulatory fatigue. By this I mean the potential the blizzard of regulation has to overwhelm bank risk management and other staff as well as the potential for it to keep your eye off the ball on other emerging risks. When you are buried in protocols dealing with a multitude of new compliance rules and regulations, what cost may this be having on your customers and your ability to focus on other risks? Regulation for what it is worth saturates the market today. In the wake of the financial crisis it almost seems too that there has become an over obsession with regulation of specific markets and risks that were contributing factors to the crash.

We now have government economists who have never once underwritten a mortgage loan determining what a high quality mortgage is. Do we really think the next crisis is going to be mortgage credit? These rules and heightened scrutiny again are natural responses to known outcomes. But to quote a former defense secretary what about the known unknowns? Many of us have publicly stated that interest rate risk may be where the next crisis emerges given the composition of bank balance sheets and where Fed stimulus will head at some point. Yet, while we find banks focusing on running the stress effects of a significant downturn in home prices, the OCC abandoned one of the better ideas emerging from the Office of Thrift Supervision; namely its interest rate risk measurement system.

As risk managers it is important to keep sight of the fact that we need to first worry about managing the risks of the institution. We can too easily be lulled into a false sense of security by focusing on what the regulators want rather than what’s in the best interest of the firm. We cannot ignore the costs of regulatory risk in a highly charged environment as bank regulation continues to be these days.

The last area of concern about regulation has to do with regulatory over-engineering. In some sense the LCR issues I pointed out earlier attest to this issue, and to some degree this issue is woven in with our desire to quantify as much as possible. Operational risk presents the best example of this issue that I can think of. Basel capital standards for advanced measurement firms require a bit more sophistication in their estimates of operational risk for capital determination. The problem with this is that as we know, operational risk is not well suited to the granular risk measurement as say market or credit risk. So we have developed a daunting array of analytical tools to empirically determine operational loss distributions. While we should
attempt to quantify such risks as best we can, I believe regulators and management for that matter can be misled into believing they have accurately depicted the level of these risks. It is in that sense that we have to continue to ask ourselves is the method representative of the exposure or is it an exercise to be performed to check the box on regulatory compliance? Summing up these themes in regulation, there’s regulation and then there is smart regulation. I’m not convinced we have seen the latter yet.

We’ve covered a lot of ground and I want to try and distill my comments into the following takeaways:

• First, establishing a strong risk governance process is essential for the long-term success of any financial institution. It cannot be imposed by regulation. Unfortunately the risk DNA of a firm I believe is endogenous which makes it extremely difficult to change a firm’s risk culture by simply injecting some regulatory requirements or bringing a few new risk managers into the firm.
• Second, beware senior management cognitive biases and be positioned for how to navigate these in changing markets.
• Third, our profession needs to cultivate the softer skills for successful risk management in addition to the quantitative side of the business. By doing so positions the risk management organization to be able to not just quantify risk, but effectively communicate and challenge alternative views where risky outcomes are seen.
• Fourth - regulation rather than helping to bring clarity and more certainty to markets has at times the exact opposite effect. Regulatory uncertainty is alive and well across the industry and in many markets because we do not yet understand the ramifications of how these regulations affect markets and financial instruments.
• Lastly, I would leave you with the observation that our profession is certainly not static. We are at the crossroads of what I believe to be extraordinary change in the stature of risk management with the organization, the way we think about managing and identifying risks and our role as a strategic partner with business. It is thus an exciting time to be a risk manager; Accountability, Vigilance, Responsiveness and Communication are the watchwords for a situationally risk aware environment.