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The Handbook of Risk management

Implementing a Post-Crisis Corporate Culture

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To Maurice

Preface

A journey has begun that leads towards a new economic model where controls of risks rebalance the excesses of the continuous quest for growth and capital efficiency.

During twenty years of economic growth separating the fall of the Berlin wall and the failure of Lehman Brothers, the world has created unprecedented wealth while adding some 3 billion consumers to its economic map. Yet the structures of the financial industry and especially the core values driving its endeavours did not change as deeply. Existing models were merely scaled up and replicated, capital efficiency remained a sole value of corporate culture. Globalization is associated with standardization and uniformity as all regulators abide by the principle of convergence.

The awaking was brutal when the interbank money market ground to a complete standstill in late 2008, which caused national monetary authorities around the world to massively intervene, or seek the assistance of the International Monetary Fund. At that point, everyone would finally recognize that the system was dysfunctional, yet so many warning signals since 2006 had been ignored or dismissed. There is abundant literature on what went wrong, the paths that led to the crisis and the lessons that can be learnt. However, a model mismatch is much deeper a problem than a crisis.

A new model is naturally necessary, which will rebalance the search for capital efficiency with the management of the risk appetite individually expressed by each company's shareholders and funding entities. Diversity, as opposed to convergence, will finally reappear as the way for the finance industry to function again as an ecosystem, a critical condition for enabling an economy of a 6.5 billion population to function.

A handful of global banks featuring standardized balance sheets and capital ratios computed on market-based data are bound to fail at one point when the pressure of repetitive tail events – the severity of which is directly linked to the concentrations of wealth they themselves create during boom times – will grow too high. Their scalability is not unlimited. The lack of diversity in strategies and purposes creates inevitable concentrations that favour the formation and inflation of asset bubbles.

The diversity of risks is unlimited and exponentially multiplied by an unlimited diversity of ways in which those risks might impact and combine. Similar risk exposure does not necessarily translate into identical sensitivity, depending on which firm or system it impacts. The companies' specifics, their traditional funding sources, their privileged customer base, the nature of their assets, their history – in one word their culture – determines the way they should adapt to risks. Each one needs to be able to manage their own balance of value creation versus risk generation, in the context of the ecosystems they operate within. How could Asian banks, for example, financing local industrial developments develop an approach to credit ratings similar to giant retail operations in the UK, mortgage specialists in the US or investment banks of Wall Street? Even if it were at all sensible to do so, the external conditions of credit, liquidity supply, currency volatility and unknown factors that direct the way sensitivity materializes make the approach totally irrelevant.

There is room for regulations imposing guidelines and core principles, but at a higher level, with respect to the spirit in which risk mitigation should be carried out by each individual corporation, within the one or multiple ecosystems they belong to. The recent trend, which consisted of centrally modelling a profile for the entire industry by rigid definitions of business lines, risk classes and uniform methodologies, achieved the opposite of what it aimed for. It impeded firms to adapt to their environment, thus increasing their idiosyncratic risks. This is assuming that tail risks were only idiosyncratic in nature-enhanced systematic risks. The rigidity and complexities of entangled regulatory rules led systematic risks to externalize into systemic risk.

Regulators should not be required to say what should be done or how much is good enough. Even it were at all possible, it could only be achieved in the context of what is known at a given point in time, and thus, by definition, is unsuited to future developments. Instilling a culture for each and everyone to learn how to live with their own risks, adapt to the changing nature of risks and how to align them with their shareholders' and customers' expectations would be far more beneficial and adaptive.

Since the Glass–Steagall Act was repealed in 1999, many bridges were thrown between the worlds of securities and banking. Financial institutions were able to seek performance through inorganic and horizontal expansion, with the aim to become 'universal', grow value and conquer markets. Simultaneously, the demographics of consumers and savers, investors and funds deeply changed their needs and their behaviour. The quest for financial returns may be unchanged but the factors of risks willingly or unwillingly embarked through alternative investment strategies are entirely new to most. As a result, opaque levels of unwanted risks were transferred across continents, industries and indirectly allocated to investors supposedly averse to those types of risks. How could holders of European pension funds end up indirectly exposed to the US subprime real estate market through funds of funds, for example? A combination of uniform strategies and regulatory limitations incentivized the moves. Firms believed they needed what they thought was a 'low hanging fruit', while regulations compelled them to operate through securities.

Just like banks, all collective investment schemes, asset managers, private wealth management companies and hedge funds need a universal tool to adjust their risk exposure to the appetite of their clients, shareholders and whoever finances their operations. They need risk intelligence.

A financial ecosystem is not necessarily a sector in a country or a region. It is defined by risk profiles, factors of exposure and a community of partners and counterparties. Each financial ecosystem needs to re-learn how to independently adapt to the unpredictability of risk events in distribution and magnitude. Just as firms need to build some 'corporate DNA' whereby their anticipation of risks and sensitivity mitigation rules have become genetic information, so the financial ecosystem communities will also individually need to develop their own code of adaptation based on risk intelligence. This requires a whole culture of communications and transparency, an unlimited body of knowledge to be built, maintained and understood.

Supranational regulators and industry representatives are needed to foster the necessary culture to create an overall understanding of risk and adapt to it. The boundaries would be no longer ratios but ethics. Requirements would not be limited to some regulatory language but extended to multilateral dialogues for the authorities to assess idiosyncratic risks and compliance while creating risk intelligence to the benefit of the entire industry. The methods would not be limited to 'carrot and stick' but become productive exchanges of information. The rules of engagement and disclosure policies would be adaptive to the overall levels of risk and volatility faced by the system at different times.

This handbook proposes a methodology derived from countless discussions around the world with banks, asset management companies of all sizes, fund managers, regulators, central banks and governments that I have been given to meet through my assignments with Thomson Reuters. In the aftermaths of the 2007–2009 crisis, each of them faces new challenges and develops new ways to rebalance the creation of shareholder or commercial value with the generation of risk exposure. It is also based on a research of only the most recent approaches from scholars and thought leaders, in an effort to picture the looming aspects of post-crisis risk management.

This handbook gathers the spirit of their endeavours, as a set of key principles aiming to inspire the readers and their firms to start codifying their own culture as elements of corporate DNA embedding the core values of risk management.

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1 Introduction: Risk is People's Business

1.1 THE ESSENCE OF CAPITALISM

Risk is the essence of free enterprise in liberal economies. The very act of incorporating a firm is an expression of risk appetite by which a number of partners will be holding liabilities to produce value and profit and meet a development objective. Meeting the revenue and profit objectives within the boundaries of the risk appetite is the mission of the executive management team. The Chief Executive Officer is the guardian of that bond between the shareholders and the board of executive directors.

The assets and human resources involved must therefore be utilized to maintain this balance between generating value and controlling risks. As such, one may argue that the discipline of managing risk has always existed. Since the 18th century's Industrial Revolution, firms have invested, created value, survived crisis, adapted to changing technology, competed against each other and weathered many crises and wars. Or have they? Few firms actually last more than 50 years. A minority may last more than 100 years. Others, on the other hand, will most likely cease to have a purpose as their shareholders lose their appetite for risk or operate in unsustainable conditions; some others might fail. In any case, these firms somehow lose the balance between generating value in reward for labour and capital and the risks involved. The very few that survive, expand and thrive usually evolve at a staggering pace, through organic and inorganic growth, continuously adapting and innovating from core business to new market niche, often transfiguring in each decade.

The transformation leading to survival is a demonstration of balance between risk and value management. Seldom a smooth transition, the history of corporations is fraught with crises, failures and restarts. More often than not, change is a painful implementation. It is the evolution of risks, the unexpected ones in particular, that seems to be pushing the boundaries of innovation by changing the conditions for survival.