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Risks and Resolutions: The 'Day After' for Financial Institutions—A conference summary

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The Chicago Fed's Supervision and Regulation Department, in conjunction with DePaul University's Center for Financial Services, sponsored its second annual Financial Institutions Risk Management Conference on April 14–15, 2009. The conference focused on risk management, headline issues, and recent financial innovations.

Materials presented at the conference are available at www.chicagofed.org/news_and_conferences/conferences_and_events/2009_sr_risk_regulation.cfm.

This year's risk conference focused on how the rapidly shifting financial and economic environment is changing the way risk is being managed. This *Chicago Fed Letter* provides a summary of the relevant research presented and discussions held by the bankers, supervisors, and academics in attendance.

Opening the conference, Ali Fatemi, DePaul University, described how rapid growth in the U.S. financial sector in recent decades led to deregulation, increased leverage,[1] and overconfidence in the industry's ability to manage risks. As we enter a new period of stricter regulation, he said, there is concern that the best and brightest workers will depart the industry in significant numbers.

Carl R. Tannenbaum, Federal Reserve Bank of Chicago, noted that the U.S. financial landscape has changed dramatically in just the past six months. The U.S. Department of the Treasury and the Federal Reserve have been exceptionally active over this period. He said that we will be identifying and debating the lessons learned for years to come. These include lessons about the assumptions and applications of financial risk-management models, as well as lessons about linkages between credit risk and liquidity risk.

Amplifying Tannenbaum's assessment, Charles L. Evans, president and CEO, Federal Reserve Bank of Chicago, outlined how an abrupt swing from extreme risk tolerance to extreme risk aversion had brought the financial system to its current state. Financial stress is also taking a toll on the "real" economy during this business cycle; i.e., the turmoil on Wall Street is affecting what's happening on Main Street. This has not always been the case historically. Gross domestic product continues to contract, and unemployment is likely to continue to rise until 2010.

Evans predicted that a number of reforms could figure into the resolution of this crisis. These include identifying systemically important institutions, rethinking how to price the safety net, and requiring higher capital—whether "exogenously" through higher regulatory minimums for capital balances or "endogenously" through putting debt holders at risk and exerting market discipline.

CEO and chief risk officer perspectives

William Downe, CEO, Bank of Montreal (BMO), argued that BMO has benefited from the diversity of its businesses, the strength of its risk infrastructure, the sound judgment of its staff, and its conservative risk culture (especially regarding

credit risk). BMO's most important lessons learned concerned liquidity and interdependencies among products and markets, especially the vulnerabilities of asset securitization.

Under BMO's risk-management program, business lines own the risks, but additional lines of defense are provided by the corporate risk-management and audit functions. BMO has historically had strong risk functions for individual risks, but has been working recently to strengthen communication across these functions.

and bottom-up framework, in which both the "tone from the top" and "escalation from staff and officers" are critical to success. The board has shown its support by establishing a dedicated board-level ERM committee.

The "biggest shocks" of the financial crisis cited by these panelists were the speed at which liquidity problems grew, the rapid decline in collateral values supporting loans, and the abrupt change in the public's perception of bankers (from positive to negative). Their most difficult decisions were recognizing higher nonperforming

To reduce systemic risk, policymakers are taking a hard look at "too-big-to-fail" and other regulatory policies, including capital requirements.

Richard Cahill, Federal Reserve Bank of New York, moderated a panel of three chief risk officers: Joyce M. St. Clair, Northern Trust Corporation; Dominic Monastiere, Chemical Bank; and Kevin Van Solkema, The Private Bank. The panelists discussed their organizations' risk-management structure and how they are responding to the global financial crisis.

St. Clair said that at Northern Trust, risk policies, tolerances, and reporting flow through an extensive committee structure at the business-line and executive levels to the board of directors. In the current economic and political climate, the bank has institutionalized and globalized its incident management process, is focusing more on emerging risks, and is paying more attention to scenario analysis and stress testing to determine capital adequacy.

According to Monastiere, Chemical Bank has a decentralized service delivery system and a local decision-making structure but also centralized procedures, operations, and controls. Monastiere's responsibilities include 15 major functions covering the full range of financial and compliance risks.

Van Solkema explained that The Private Bank began to implement enterprise risk management (ERM) relatively recently, in the summer of 2008. Consequently, ERM has rapidly evolved into a top-down

loans and charge-offs, developing action plans for problem loans, and changing business strategies for reputational reasons.

Supervisory lessons learned

Tannenbaum also led a panel on the lessons learned thus far through the bank supervision process. It featured Jon D. Greenlee, Board of Governors of the Federal Reserve System; Kathryn Dick, Office of the Comptroller of the Currency (OCC); and Mark J. Flannery, University of Florida.

Greenlee reviewed indexes of stress in financial markets, as well as those of deleveraging (i.e., reducing leverage, whether at the level of the individual, the firm, or the financial system). The "originate-to-distribute" model, where the originator of a loan sells it to various third parties, has largely been abandoned for the present. It may involve simpler structures once it returns. In addition, given the complexity of the financial system, and the nature of the "shadow" banking system (comprising nonbank financial institutions, which are less regulated than banks), risks originated in unforeseen places and were transformed in unforeseen ways. Finally, Greenlee noted that incentives play a critical role in both risk-taking and risk management.

Dick recounted key lessons learned at the OCC. They are as follows:

- Underwriting standards matter;
- Risk concentrations accumulate and need to be controlled;
- Asset-based liquidity matters;
- Systemically important firms need "state-of-the-art" infrastructure; and
- Capital issues (including quantity, quality, planning, and procyclicality issues[2]) are paramount.

She also covered an array of risk-management topics being explored by the OCC, including greater transparency of disclosures and the need to address excessive complexity of both structured products and organizational structures.

Flannery emphasized the impediments to risk management and risk supervision. Risk assessments differ across observers at any point in time. In addition, risk managers must identify outcomes that are unlikely to happen; therefore, they are wrong much more often than they are right. Expanding on Greenlee's earlier point about incentives, Flannery said that power within a firm flows to those who are making money; i.e., it goes to risk takers rather than risk managers. Supervisors face all these challenges, plus political pressure if they try to limit currently profitable activities.

The too-big-to-fail problem

Gary H. Stern, president and CEO, Federal Reserve Bank of Minneapolis, concentrated on the too-big-to-fail (TBTF) problem[3] in his remarks. He indicated that the current financial crisis has reaffirmed four lessons learned from earlier crises: 1) the need to put uninsured creditors of TBTF firms at risk; 2) the value of preparing in good times; 3) the limitations of a resolution regime based on FDICIA (the Federal Deposit Insurance Corporation Improvement Act of 1991);[4] and 4) the limitations of traditional supervision and regulation.

In order to reduce expectations of bailouts and reestablish market discipline, Stern said, policymakers must convince uninsured creditors that they will bear losses when their financial institution gets into trouble. In addition, a credible commitment to imposing losses must be built

on reforms that directly reduce the incentives that lead policymakers to bail out uninsured creditors (i.e., provide significant protection for them).

Stern suggested that, without sufficient preparations, policymakers—even under a FDICIA regime—will end up supporting uninsured creditors of financial institutions perceived to pose systemic risk. Similarly, bank supervision has proven slow to identify risks and is prone to forbearance, as shown by its failure to prevent excessive lending to commercial real estate ventures.

The TBTF problem was also the subject of a panel moderated by Elijah Brewer III, DePaul University. The panel featured David R. Casper, BMO Capital Markets; Ron J. Feldman, Federal Reserve Bank of Minneapolis; and Robert A. Eisenbeis, Cumberland Advisers. Brewer began by raising the question of whether it would be truly catastrophic to allow large firms to fail, indicating that it had never really been tried.

Casper listed the potential adverse repercussions of allowing a systemically important institution to fail. However, preventing such failures also has a number of negative impacts, such as moral hazard (by seeming to reward irresponsible behavior), distortions in competition, artificial incentives for growth, and costs to taxpayers. He recommended several measures to limit TBTF: maintaining uncertainty around government intervention (i.e., not stating explicitly the circumstances under which a government bailout will be forthcoming); enhancing capital requirements and board/senior management accountability; improving supervision; creating a systemic risk regulator; improving transparency in credit default swaps and other over-the-counter (OTC) markets;[5] and improving resolution processes.

Feldman outlined the characteristics of an effective "macro-prudential" supervisor. Such an entity would likely need, for instance, practical, hands-on knowledge of institutions. In addition, to complement its own monitoring, it should use firms' own analyses of their exposures to counterparties and other spillover factors, as well as market assessments of risk, to the extent possible. Since it is hard to predict specific events that could precipitate a failure, more time should be spent on determining appropriate responses in the event of a failure.

Eisenbeis argued that the concept of systemic risk has become broader and vaguer over time. There is no workable definition of "systemically important" that could be applied to a firm before an actual failure. In addition, creating a systemic risk regulator may not be a panacea and could produce conflicts of interest and other incentive problems. To limit systemic risk and TBTF, Eisenbeis recommended, among other measures, limiting excessive leverage and complexity and considering unwinding scenarios as part of the bank supervision process.

Regulation and capital

The future of regulation, including capital requirements, was considered by a panel moderated by Brian D. Gordon, senior professional, Federal Reserve Bank of Chicago. The panelists were Anil K Kashyap, University of Chicago; Edward F. Greene, of Cleary Gottlieb Steen and Hamilton LLP; and David Palmer, Board of Governors of the Federal Reserve System.

Kashyap focused on capital regulation. He proposed that, other things being equal, capital requirements should be higher for banks that pose greater potential systemic risk (i.e., larger banks and banks with a higher proportion of illiquid assets or of short-term debt). He also proposed that failing institutions should be forced to recapitalize, rather than depending on large amounts of government resources to prop them up. This could be done through "contingent equity," a long-term debt instrument that converts to equity under specific conditions. Banks would issue these bonds to private investors before a crisis. If triggered, the automatic conversion of these bonds into equity would keep a weakened bank solvent at no cost to taxpayers.

Greene addressed likely changes in the regulation of key markets and instruments, as well as the concept of a systemic risk regulator. He expressed concerns about the effects of short selling[6] during the current crisis. He also predicted changes in derivatives markets,[7] such as increased use of central counterparty clearing. For securitization markets to come back, key issues are better allocation of risk to, and licensing of, loan originators, as well as enhanced disclosures. While endorsing the goals of having a systemic risk regulator, Greene emphasized the difficulties of implementing such a concept in the current highly fragmented U.S. regulatory system.

Palmer concentrated on banks' internal assessments of capital adequacy. Banks face a number of challenges in this area, including the need for fundamental processes to identify and measure risks. Stress testing is also important in estimating capital needs and evaluating available capital resources. It should be used to challenge assumptions in existing models and to look at potential outcomes not captured in them. Given the inevitable uncertainties surrounding the capital assessment process, banks need to maintain strong capital buffers and have an overall sense of humility about what they understand and what they can measure.

The future of financial innovation

A panel on financial innovation, which was moderated by John W. Labuszewski,

Charles L. Evans, *President*; Daniel G. Sullivan, *Senior Vice President and Director of Research*; Douglas D. Evanoff, *Vice President, financial studies*; Jonas D. M. Fisher, *Vice President, macroeconomic policy research*; Daniel Aaronson, *Vice President, microeconomic policy research*; William A. Testa, *Vice President, regional programs, and Economics Editor*; Helen O'D. Koshy and Han Y. Choi, *Editors*; Rita Molloy and Julia Baker, *Production Editors*.

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Chicago Mercantile Exchange, featured David Marshall, senior vice president, Federal Reserve Bank of Chicago, and Gerald A. Beeson, Citadel Investment Group LLC. Labuszewski detailed how his firm continues to innovate in a distressed economy, with particular emphasis on bringing central counterparty clearing to the OTC derivatives market.

Marshall analyzed the underlying causes of the financial crisis and related policy issues. A massive inflow of capital from abroad led to low interest rates, underpricing of tail risk,[8] overprovision of housing loans to nontraditional borrowers (e.g., those with poor credit histories), and overpricing of residential real estate. Financial innovation is always potentially disruptive, changing the distribution of returns in unpredictable ways and making tail risk events more likely. Marshall suggested that policymakers take a serious look at this "dark side" of financial innovation, as well as managerial incentives, the disruptive effects of housing mispricing, and (especially) measurement and containment of tail risk.

Beeson noted that much needed innovation had occurred within the derivatives market in recent years. However, many of these innovations, in risk transfer and funding, have been shut down, perhaps permanently. In addition, continued impairment of the securitization market will hinder risk transfer between providers of credit and pools of available capital.

Past crises

William M. Isaac, The Secura Group, played a key role at the Federal Deposit Insurance Corporation (FDIC) during the banking crises of the 1980s. He said that the current financial crisis is much less severe than the earlier ones. The 1980s saw massive problems in the economy and thousands of bank and thrift failures. In the current crisis, however, a relatively manageable amount of potential losses on subprime mortgages has been amplified by misguided regulatory policies, he said.

Isaac identified several such policies. One is fair value accounting, which has caused assets to be marked to unrealistic, fire-sale prices in the absence of a functioning market and thereby destroyed hundreds of billions of dollars of capital. Also misguided, Isaac said, were decisions by the Securities and Exchange Commission to allow "naked selling" (selling a financial instrument short without first borrowing it or ensuring that it can be borrowed) and to eliminate the requirement that short sellers could sell only on an uptick in the market. Isaac also criticized the Basel capital rules for exacerbating cyclical problems through the use of backward-looking models. Loan-loss reserving policies and FDIC insurance premiums have also had highly procyclical effects. Finally, Isaac argued that policymakers created a crisis atmosphere by the way large failures were handled and by using inflammatory rhetoric when requesting emergency taxpayer funds.

Conclusion

Overall, the conference built effectively on last year's meeting and reflected the new directions both risks and policy responses have taken since that time. The sponsors were gratified by the enthusiastic response to this event.

[1] Leverage refers to the proportion of debt to equity (also assets to equity and assets to capital). Leverage can be built up by borrowing (on-balance-sheet leverage) or by using off-balance-sheet transactions.

[2] Procyclicality refers to features that amplify the swings in the business cycle.

[3] TBTF refers to the provision of discretionary government support to the uninsured creditors of financial institutions perceived to pose systemic risk.

[4] FDICIA mandated a least-cost resolution method but allowed a "systemic risk exception."

[5] An OTC market is a decentralized market of securities not listed on an exchange.

[6] Short selling is the selling of securities or commodities that the seller does not yet have but expects to cover at a lower price.

[7] A derivative is a financial instrument whose characteristics and value depend upon those of an underlier—typically a commodity, bond, equity, or currency. Futures and options are examples of derivatives.

[8] Tail risk is a form of portfolio risk that arises when the possibility that an investment will move more than three standard deviations from the mean is greater than what is shown by a normal distribution.