

# Risk Management: Where to From Here?

Important Industry Lessons from the Financial Crisis

The Asian Banker Summit 2009  
The Risk, Regulation & Governance Conference  
*Global Banking Reform & Practical Implications*

Beijing, 12 May 2009

Dr. Mark Lawrence  
Managing Director, Mark Lawrence Group  
Senior Advisor to McKinsey & Company  
[mark@marklawrencegroup.com](mailto:mark@marklawrencegroup.com)

## Some possible perspectives in the wake of the Financial Crisis ...

- **“Risk models have failed” ...**
- **“Basel II has failed” ...**
- **“Risk Management has failed” ...**

*So... where to, from here???*

## Crisis has exposed massive failures in risk management ...



As long as the music is playing, you've got to get up and dance. We're still dancing.

– *Charles O. Prince, CEO, on the leveraged lending market*  
*The Financial Times, July 9, 2007*



Firms made strategic decisions to retain large exposures... that **far exceeded the firms' understanding** of the risks.

– *Senior Supervisors Group Report, March 2008*



Lack of comprehensive approach... **key risks not identified.**

– *Final Report, IIF Committee on Market Best Practices,*  
*July 2008*

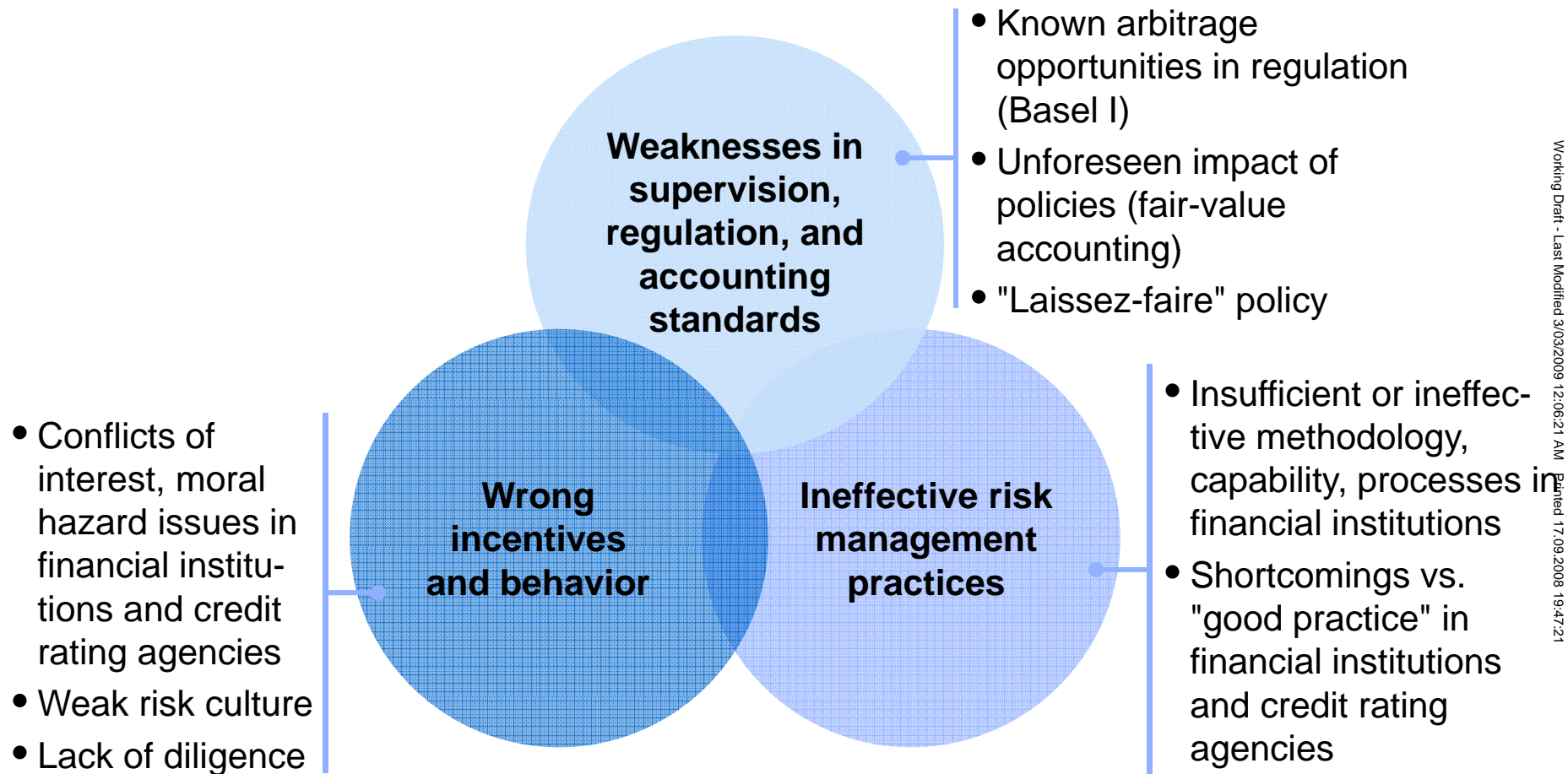
## Discussion topics

**Risk management lessons learned and key global industry recommendations**

Key challenges for risk management

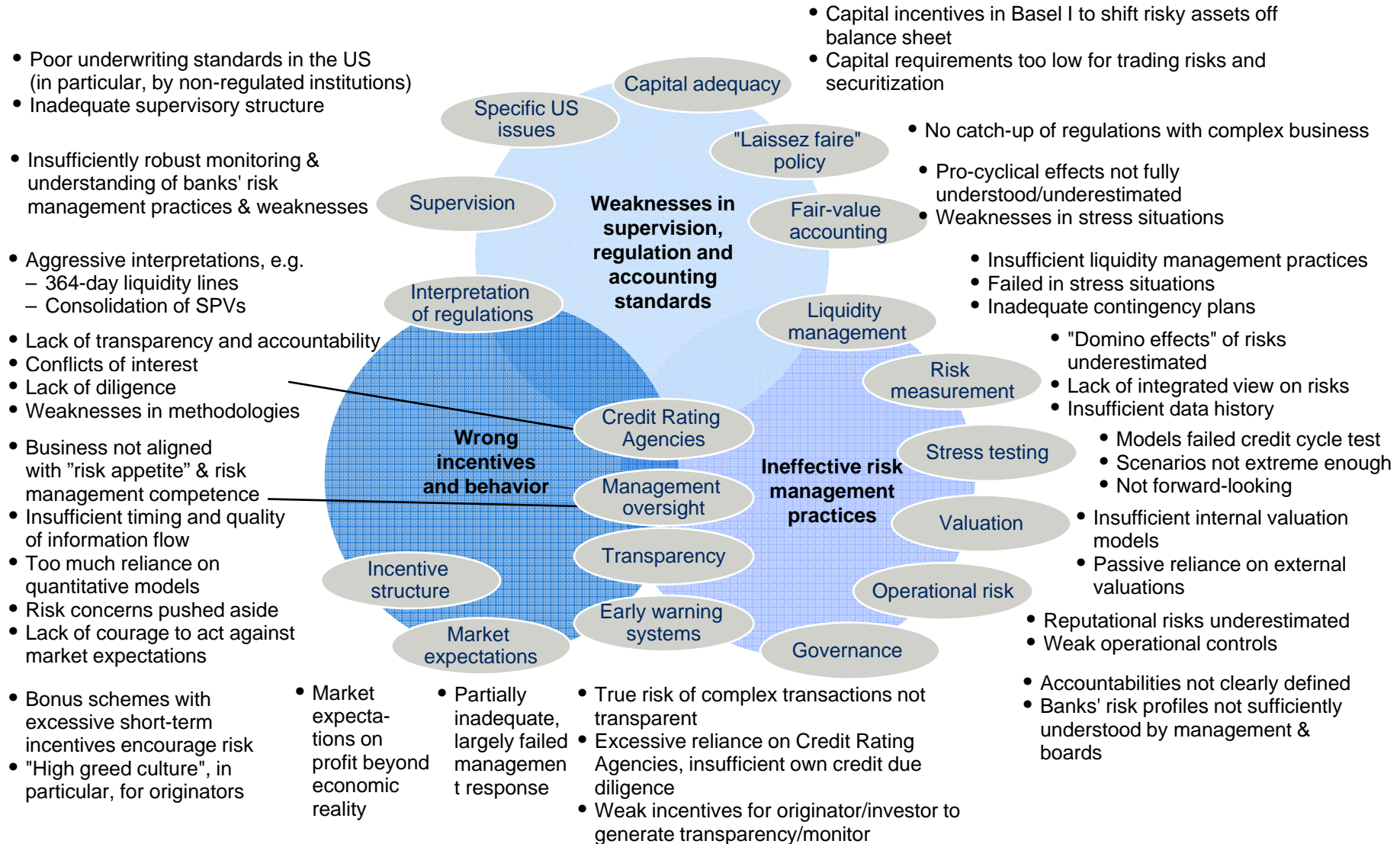
The risk management imperative today

# Firms' conduct was based on multiple structural flaws in regulation, risk management, and incentives



# Crisis had many important causes, including risk management failures, weak culture and poorly aligned incentives

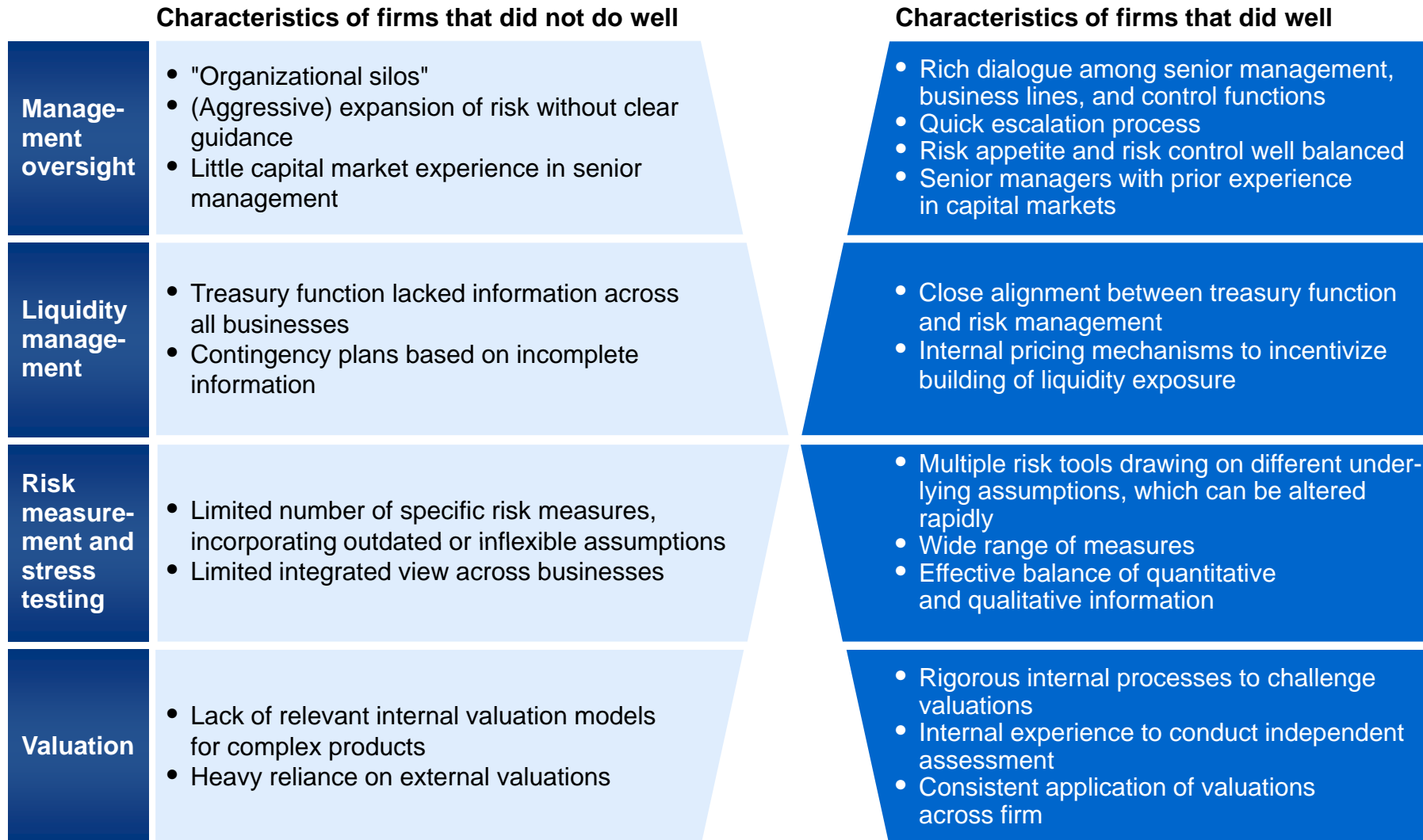
SELECTION



Working Draft - Last Modified 3/03/2009 12:06:21 AM Printed 17.09.2008 19:47:21

# Key lessons learned from risk management failures and successes are driving the global industry response

SELECTION



Working Draft - Last Modified 3/03/2009 12:06:21 AM Printed 17.09.2008 19:47:21

1 This assessment is based on an analysis of 11 of the largest banks and securities firms

SOURCE: Senior Supervisors Group; Observations on Risk management Practices during the Recent Market Turbulence (March 6, 2008)

## The IIF Committee on Market Best Practices has recommended 6 areas for industry action in its July 2008 final report

- The global industry response to the credit and liquidity crisis was formulated through the Committee on Market Best Practices (CMBP) of the Washington-based Institute of International Finance (IIF)
- The Committee (consisting of representatives from over 65 IIF member institutions, including rating agencies and investors) engaged 6 Working Groups to address key areas of focus
- Its July 2008 report contains Principles of Conduct and >100 specific recommendations in each of 6 main areas for industry action

### Areas for industry action

- Risk Management
- Compensation Policies
- Liquidity Risk, Conduits and Securitization
- Valuation
- Credit Underwriting, Ratings and Investor Due Diligence in Securitization Markets
- Transparency and Disclosure



***Next steps are industry follow-up and implementation***

Working Draft - Last Modified 3/03/2009 12:06:21 AM Printed 17.09.2008 19:47:21

## Risk Management – Key Recommendations

**Key Q: which of these recommendations are most relevant for Asian banks?**

<b>Risk culture and accountability</b>	Develop a robust risk culture - incorporated in the way the firm operates - covering all areas and activities. Accountability for risk management should be a priority for the whole institution
<b>Role of the Board</b>	Senior management, particularly the CEO, is responsible for risk management; the Board has an essential oversight role
<b>Role of the CRO</b>	Ensure that the Chief Risk Officer (CRO) can influence key decision makers within the firm, with the mandate to ascertain that the firms's overall risk level is consistent with its risk appetite & to provide a thoughtful, integrated view of overall risks; support senior management by identifying emerging risks & concentrations
<b>Comprehensive perspective</b>	Define and articulate risk appetite and ensure its adoption throughout the firm; ensure consistency between risk appetite and strategy; take an integrated approach to capturing all sources of risk (notably off-balance sheet exposures); take into account technical limitations of risk models, such as Value at Risk (VaR)
<b>Official sector considerations</b>	The Basel II framework for securitization should be improved, allowing options for firms to use external ratings in conjunction with internal models; greater collaboration between the official and private sectors is needed in the area of stress testing, promoting practices under a Pillar 2 approach suitable to the specifics of each firm

## Compensation – Key Recommendations

<b>Shareholders' interests</b>	Incentives should be aligned with long-term, firm-wide profitability
<b>Risk-adjusted compensation</b>	Incentives should not induce risk-taking in excess of the firm's risk appetite; firms should base compensation on risk-adjusted performance
<b>Severance pay</b>	This should take into account realized performance for shareholders over time, and consider the circumstances of severance
<b>Transparency</b>	The industry must show leadership in developing a better, more transparent approach to compensation practices

## Liquidity – Key Recommendations

<b>IIF March 2007 liquidity report</b>	Recommendations of the IIF's 2007 Principles of Liquidity Risk Management have been validated by recent experience and updated in the Final Report; firms should complete their implementation
<b>Funding and stress testing</b>	Firms should diversify their funding sources for asset portfolios held for liquidity purposes; firms should ensure that stress testing includes contingent liquidity exposures
<b>Contingency planning</b>	Firms that rely on market funding, particularly asset securitization or conduits, should conduct rigorous contingency planning for market liquidity risks
<b>Official sector considerations</b>	Central banks have made an essential contribution to market liquidity – new tools should be kept available for use when needed. Greater clarity of central banks' roles in firm-specific and market-related crises would also be welcome. For firm liquidity, standards should be better harmonized and based on qualitative rather than specific quantitative requirements. Supervisory dialogue and review of off-balance sheet issues under Pillar 2 is preferable to revision of regulatory capital rules

## Valuation – Key Recommendations

<b>Fair-value accounting</b>	Essential for global capital markets, fosters transparency, discipline and accountability. However, mark-to-market valuation is challenging in illiquid markets
<b>Valuation in liquid markets</b>	Comprehensive technical dialogue should address the problems of assigning appropriate values in dislocated or illiquid markets
<b>Convergence</b>	Aligning U.S. GAAP and International Accounting Standards is more critical than ever and should be accelerated
<b>Official Sector Considerations</b>	<ul style="list-style-type: none"><li>• Dialogue needed – A high-level dialogue of all relevant parties with both standard setters should consider the effects of mark-to-market techniques during times of excess liquidity as well as illiquid markets, and the apparent pro-cyclical effects with macroeconomic implications that concern many in the private and official sector</li><li>• Standard setters should provide additional guidance on valuation in inactive, illiquid and/or stressed market conditions</li></ul>

## Credit underwriting, Ratings, and Investor Due Diligence – Key Recommendations

<b>Broad scope</b>	Recommendations cover the process from origination and underwriting through to ultimate investors. Firms should subject assets they help originate and distribute to the same credit due diligence standards as used for similar assets that are to be carried on their own balance sheets
<b>External review</b>	Establish an external review of rating agencies' internal processes for monitoring and validation of models against defined industry standards
<b>Separate rating scale</b>	Rating agencies should introduce a differentiated rating scale for structured products
<b>Official sector considerations</b>	<ul style="list-style-type: none"><li>• Underwriting – Non-bank mortgage originators should be held to the same standards as banks on consumer protection and loan origination</li><li>• Authorities should consider external review of internal processes within Credit Rating Agencies</li></ul>

## Transparency and Disclosure – Key Recommendations

<b>More accessible and useful information</b>	Better disclosure on products is required to restore market confidence, as is more transparency about firms themselves
<b>Structured products</b>	Recommendations here include <ul style="list-style-type: none"><li>• A short-form summary of the offer document</li><li>• Global harmonization of market definitions &amp; structures</li><li>• Common platforms (such as data portals) for improved access to information on structured products</li></ul>
<b>Firms' risk profiles</b>	Institutions should ensure that their disclosure provides a sufficient overview of their current risk profiles – including securitization activities and off-balance sheet exposures
<b>Official sector considerations</b>	Regulators should support the private sector's efforts to improve transparency, with particular reference to harmonization of disclosure requirements among different jurisdictions. The official sector should work closely with industry and market participants to improve market understanding of Pillar 3 disclosure content. Disclosure requirements should be based on a risk- and principles-based approach to qualitative as well as quantitative information

## Discussion topics

Risk management lessons learned and key global industry recommendations

**Key challenges for risk management**

The risk management imperative today

## Key challenges for risk management

- These include
  - **Seeing** how the external environment is changing & perceiving the drivers of these changes (e.g., US house price declines, diminishing market liquidity)
  - **Understanding** the current and potential impacts of these changes across all businesses, portfolios and geographies
  - **Acting** quickly to reduce risk when necessary
- All 3 of these tasks are challenging in practice!
- In particular, the **aggregate, integrated risk profile of the firm & the way this is changing is** fundamentally opaque, to insiders as well as to outsiders, and very **challenging for firms to properly understand**
- **Essential for market confidence to increase transparency of risk profiles of financial institutions**, not just structured products
- **But: statistical tables have only limited utility** - note the very important differences between statistical disclosures to the market **vs. internal risk reports**, which contain an integrated view of risks and descriptive analysis of what is new, changing or growing rapidly, etc...

## Establishing a robust “Risk Culture” is of paramount importance in ensuring effective risk management – ability to see, understand and act

- In the view of many, ***culture is the single most important determinant*** of risk management effectiveness
- Important to understand the sheer ***impossibility of knowing everything that you need to know*** about emerging risks & rapid changes to the risk profile of the firm ***through formal channels*** (committees, risk reports etc ...)
- Therefore, ***effective “informal” channels*** for information ***are essential***
- In particular, to balance risk & return at every level, firms should
  - Deliberately ***create an environment that encourages and values dialogue about risk***
  - ***Make it safe for employees to question/challenge/escalate*** things that they don’t understand, and then ***reward*** this behavior ...
  - This is absolutely essential in order to ***ensure that ‘bad news travels’*** upwards quickly, but extremely difficult to do!
  - Risk culture is the responsibility of the Board & CEO – ***CEO must lead by example, continually emphasising the importance of properly understanding risks*** and seeking to objectively balance risk & return ...

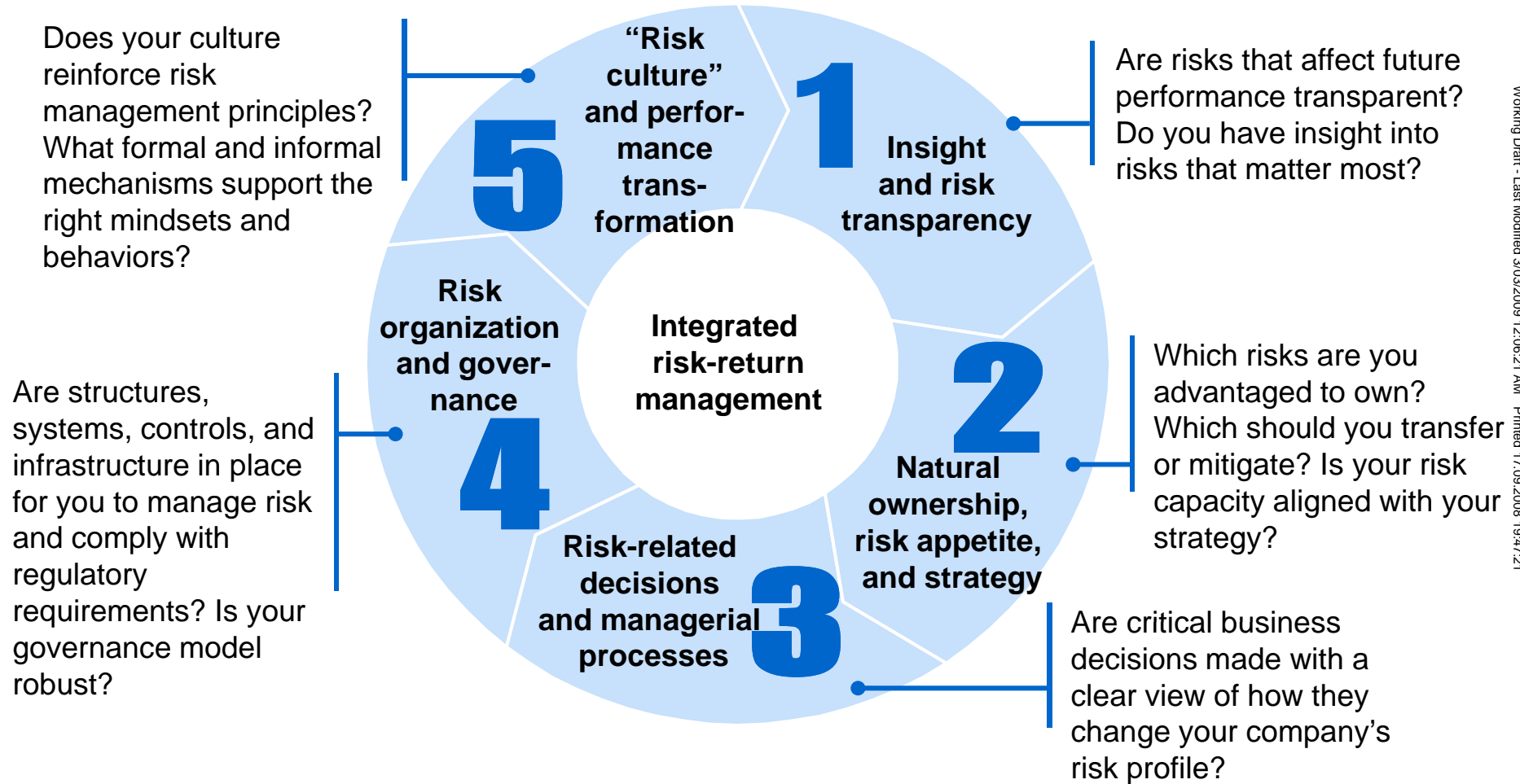
## Discussion topics

Risk management lessons learned and key global industry recommendations

Key challenges for risk management

**The risk management imperative today**

# Creation of a robust, integrated risk management framework is now imperative for survival and sustainable performance & growth



# Banks need to first “fix the fundamentals” of risk management ...

1

## Transparency

- **Ensure full transparency into important risks and develop integrated view of risks across all businesses** (e.g., redesign risk reporting, stress test for often substantial tail-risk, focus on what is changing, new or growing rapidly, descriptive analysis to drive mgmt action)
- **Benchmark against relevant IIF Market Best Practices recommendations**

2

## Ownership

- **Assess and adjust portfolio to reflect current realities** (e.g., redirect strategy away from businesses consuming scarce capital and liquidity or with inadequate risk management capabilities, reduce waste in capital & funding)

3

## Processes

- **Enhance capabilities in end-to-end credit risk management** (e.g., strengthen collections, workout strategies and execution)
- **Leverage Basel II investments to capture value**
- **Respond rapidly to regulatory changes**

4

## Governance

- **Fix risk organization gaps and empower risk management** (e.g., resolve CRO/CFO conflicts, proper separation of duties, Risk independence)
- **Ensure appropriate risk accountability** (e.g., reinforce BU-ownership and responsibility as “first line of defense”)

5

## Culture

- **Increase risk awareness across the bank & strengthen risk culture** (e.g., strive to consciously balance risk & return at every level through questioning & open dialogue, foster culture of vigilance in front-, mid-, and back-offices, launch education & cultural change programs)

## ... and then go beyond fundamentals to increase resilience

- 1 Transparency**
  - **Improve understanding and foresight on structural, systemic and emerging risks**
  - **Make unstated assumptions explicit** (e.g., home price appreciation)
- 2 Ownership**
  - **Complexity: if you don't understand it, don't own it!**
  - **Don't grow more than your risk appetite & capabilities allow**
  - **Maintain perspective through-the-cycle** (e.g., “lean against the wind”)
- 3 Processes**
  - **Embed risk in strategic planning and budgeting** (e.g., understand and accept risk implications of operating plans and growth targets)
- 4 Governance**
  - **Empower CRO and risk organization to partner with business** (alignment of control functions/CFO/CRO, right mindset, skills, profile)
  - **Make Board and management risk oversight effective** (e.g., ensure Board has risk skills/experience, avoid socialized accountability for risks)
- 5 Culture**
  - **Make importance of strong risk culture explicit** (e.g., ensure “bad news travels”, codify principles & include culture in performance assessment)
  - **Align risk-based incentives** (e.g., compensation based on risk-adjusted performance, deferred payouts and claw-backs)

### 3 immediate CEO priorities

#### Survive

- Ensure sufficient capital and liquidity – key to survival
- Review & reduce portfolio risks as needed
- Improve transparency of risk profile

#### Enhance risk mgmt capabilities

- Make steady progress on “Fixing the Fundamentals” of Risk Mgmt then “Go Beyond” to fix weaknesses & increase resiliency

#### Seize opportunity

- Look for opportunities to
  - Realign/optimize business model under new regulatory capital regime
  - Buy attractively-valued assets
  - Cherry-pick talent



# Risk Management: Where to From Here?

Important Industry Lessons from the Financial Crisis

The Asian Banker Summit 2009  
The Risk, Regulation & Governance Conference  
*Global Banking Reform & Practical Implications*

Beijing, 12 May 2009

Dr. Mark Lawrence  
Managing Director, Mark Lawrence Group  
Senior Advisor to McKinsey & Company  
[mark@marklawrencegroup.com](mailto:mark@marklawrencegroup.com)