

Commentary: Regulators' Recommendations Are an Exercise in Fantasy

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On October 21, 2009, the Senior Supervisors Group (SSG) delivered its recommendations, entitled "Risk Management Lessons from the Global Banking Crisis of 2008," to the Financial Stability Board (FSB).

The FSB was formed by the G-20 group of nations to recommend regulations that can be adopted by all G-20 members with a view to avoiding the next financial crisis. Each of the G-20 members is concerned that if their regulations are perceived as too strict, financial services firms will relocate to more business friendly jurisdictions, a behavior popularly derided as "regulatory arbitrage." So, the idea is that the FSB will propose regulations that everyone will agree to adopt, a principle known as "convergence," thereby removing the economic incentive to engage in regulatory arbitrage.

The SSG is composed of regulators from seven nations: Canada, France, Germany, Japan, Switzerland, the United Kingdom and the United States. While all other nations sent representatives from one regulatory agency, the United States sent representatives from four: The Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency and the Securities and Exchange Commission. The United Kingdom sent representatives from the Financial Services Authority, which is roughly the SEC's counterpart in Britain, but not from the Bank of England, which has responsibilities equivalent to the Fed. The US CFTC was not represented, although most of the regulators that supervise futures markets in other nations were represented.

Most remarkable in its absence, neither the College of European Securities Regulators (CESR), which advises the European Commission, nor the European Central Bank (ECB), sent representatives to the SSG. As a result, the European Union, which is the largest single entity in the G-20, was not represented on the SSG.

The SSG's report describes the efforts taken by banks and broker-dealers since the crisis ensued to firm up their risk management functions in ten major areas. We have witnessed several catastrophic banking failures at global banking institutions, and all major US banking institutions in the United States required life support from the US taxpayer to survive. The US experience was more or less repeated throughout the G-20. It is vast understatement to say that the crisis revealed widespread deficiencies in risk management.

So, in light of this near-death experience, what has the patient done? Quit smoking? Gone back on the blood pressure medication? Given up high cholesterol meals? Resumed the fitness program? The answer from the SSG is, “not much.”

To be fair, the banks claim that much has been done. They have appointed some people to their boards with financial expertise and made efforts to train the others. Risk management departments have received more resources, and risk management officers now sit on management committees. Risk management officers now formally report to a Chief Risk Officer at most firms, rather than to a business line executive. Firms report spending a lot more attention to risk, and to that end, have taken steps to improve internal control of liquidity, which should enable them to better withstand adverse events.

On a further positive note, the collapse of Lehman, followed by AIG, vividly demonstrated the exposure of our global banking system to counterparty risk. The firms that were able to react quickly to these events fared much better. As a result, most firms reported substantial investments in counterparty risk systems.

On the other hand, there is little evidence that boards are actually being involved in risk decisions. Banks are not spending the resources to develop comprehensive risk assessments, so risk statements fail to indicate how they would respond to adverse economic events. Moreover, most global banks lack the systems to analyze risk on a firm-wide basis. Firms claim to be implementing stress tests, with management support, but most firms lack the infrastructure to conduct such tests. Projects to remedy these deficiencies are only in the planning stages.

The SSG also reported continuing deficiencies in valuation practices, which means that positions are not being marked realistically. Firms continue to resist efforts to move over the counter derivative positions into an exchange-traded environment, which, in the view of the SSG, unnecessarily increases clearing and settlement risks. Firms have, however, improved their clearing and settlement practices for OTC derivatives.

The banks did not share the SSG’s dim view, arguing that much had been accomplished to shore up their risk management. Perhaps it is all a matter of whether one views the glass as half full or half empty. But, the SSG’s report is particularly dismal in its discussion about the sustainability of risk management improvements.

The SSG points out that firms have generally undertaken improvements that amount to “low hanging fruit,” projects that do not require large investments or significant changes in culture. So, for example, changes in reporting structure, or adding a chief risk officer to a few management committees, are easy to accomplish. Similarly, most firms have systems to evaluate various risks. Changing the focus of those systems may involve some programming, but doesn’t entail a huge investment in infrastructure.

It is also easy to reverse these alterations when things improve. So, when firms are able to breathe easier, and the regulators stop spending so much time in their offices, they can quietly remove the obnoxious risk officers from their management committees, reporting lines can be rethought, and the programmers can be reallocated to more interesting projects than risk management.

To achieve sustainability, the SSG thinks firms should recast their compensation structures. Risk management personnel, in the SSG's view, should be compensated on a par with revenue producers.

It all comes down to compensation in the end.

As a lawyer, I am sympathetic with the SSG's position. Much of what lawyers do falls within the category of risk management.

It is also true that the "senior supervisors" who participated in the preparation of the SSG's report arguably fall within the category of risk management within their agencies. For example, it does not appear that Chairperson Mary Schapiro represented the SEC on the SSG, or for that matter, the head of any SEC division. Like risk management officers everywhere, the members of the SSG are smart people who make less money and bask in less glory than the "rainmakers" at their agencies. It would be only natural if they considered it unfair that they are not rewarded equally.

But this is a fact of life throughout the business world. Risk officers, and others who toil in the trenches to keep a firm on its feet in difficult times by protecting the liability side of the balance sheet, never receive the compensation and other rewards that are distributed to the firm's revenue producers.

All of the things the SSG would have banks do to avoid the next financial crisis, as well as emerge intact from this one, cost money that does not immediately improve the bottom line. Any firm that shores up its risk management capacity along the lines recommended by the SSG will appear less profitable than its more profligate competitors. Its investors will flee, it will lose its ability to compete, and it will fail. At least a firm that fails in the midst of a global crisis has company.

The only way to change this calculus is through regulation. If all firms are required to emphasize risk management, and diminish revenue production, then no firm can succeed by taking larger risks than its competitors.

We are at a regulatory crossroads. Throughout the G-20, there is substantial agreement on the causes of the financial crisis. All agree that everyone must adopt similar regulations if we are to avoid the next crisis.

Some additional regulation will emerge from all of this, and there will be some convergence. There will be a greater emphasis on risk management.

Will enhanced regulatory convergence go so far that risk management officers receive the same compensation and glory as their revenue-producing brethren? That's a much different world than the one I have known, a realm of fantasy.