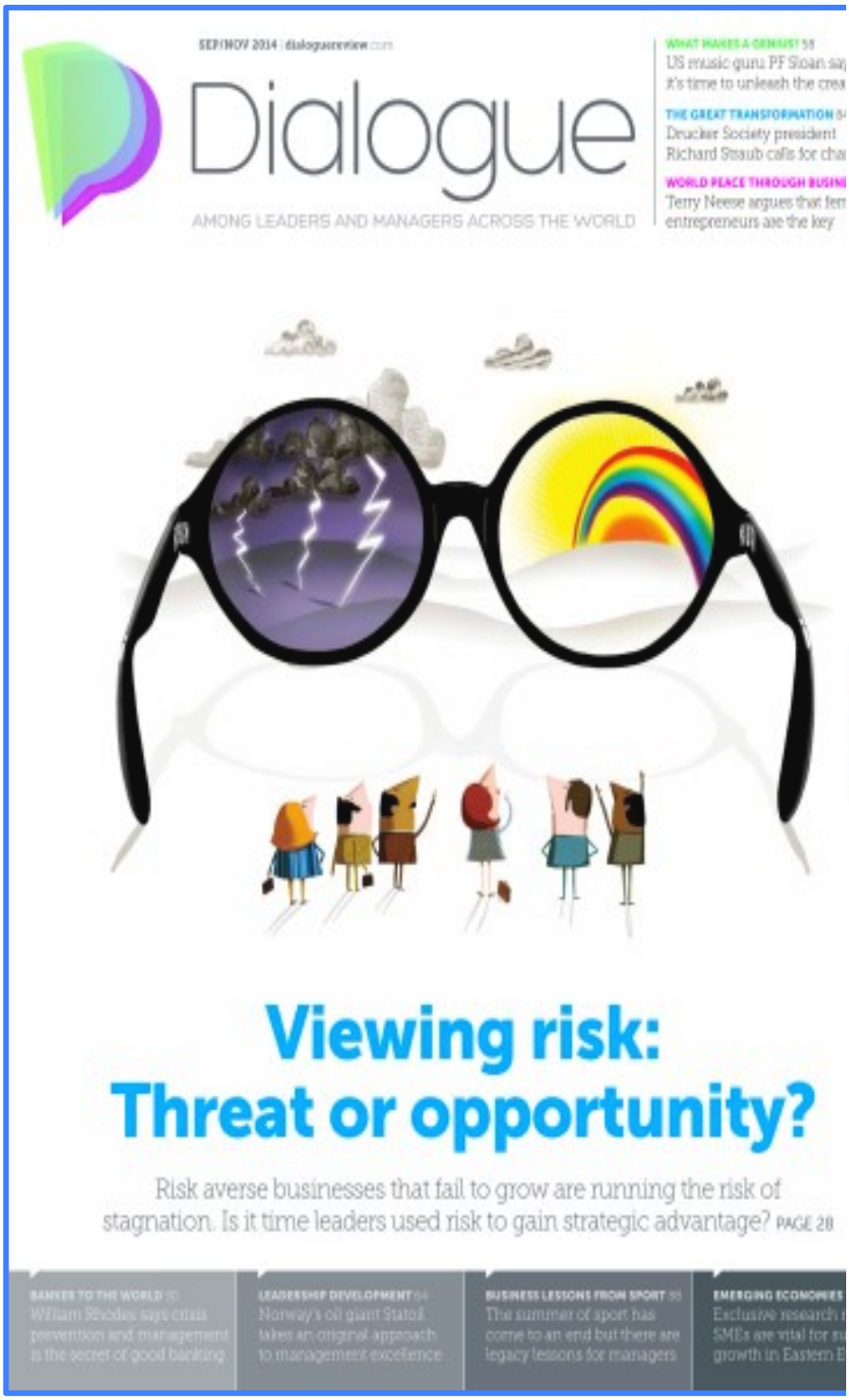
Managing Risk by William Rhodes



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Managing risk: the key to good banking by William Rhodes

By Kyomi Wade | on September 16, 2014

The 2008 financial disaster exposed devastating failures in risk management. William Rhodes explains the importance of creating effective procedures for crisis prevention and crisis management.

The 2008 financial crisis underscored both failures in risk management by several banks, as well as failures by many official supervisory authorities to perform effective banking over-sight. This crisis, like so many before it, demonstrated how crucial it is that managers and boards of banks constantly and consistently pursue approaches that ensure integrity and trust are the guiding principles of their institution's corporate culture. The critical challenge is for the management of financial institutions to develop effective mechanisms for both crisis prevention and crisis management.

In 1990, after almost a decade of representing Citibank in negotiating many facets of what has become known as the Latin American debt crisis, I served as the senior risk officer at Citibank and I was responsible for introducing a new risk-assessment system called "Windows on Risk". One of its important achievements was predicting the Asian financial crisis in 1997-1998 and this enabled Citibank to minimize its exposure to the region.

"Windows on Risk" involved tracking 14 distinct risk factors: client credit worthiness; industry risks; product risks; obligor (debtor) concentrations; global real estate risks; country risks; counterparty trading risks; price, interest rate, exchange rate and commodity risks; liquidity risks, equity and debt risks; distribution and underwriting risks; legal risks; audit risks; and technology risks.

Scenarios were developed to evaluate multiple risks simultaneously in a complex matrix approach. The study sought to consider "what if" scenarios and to assign weightings to the likely impacts of "trip wires", such as natural disaster, a sudden governmental change and a key change in the macro economic situation. Detailed data analysis and expert judgement combined to make the system work. The findings influenced the day-to-day work of Citibank's managers as they considered credit and operational and other risks.

Leaders need to have the vision to call problems early, and then you need to take rapid action to head them off. This means senior management in a bank sounding warnings, instructing managers to reduce exposures and reviewing existing strategies. This can save billions of dollars as well as reputations.

The matrix approach of placing knowledge on 14 different risk indicators, alongside each other simultaneously, can create comprehensive pictures of complicated situations and provide windows into evolving developments.
Risk management needs not only to provide information and controls on business today, but also to focus on prospects so that preventive actions can be taken in a timely fashion.

William Rhodes is a Brown University professor at large. He is formerly senior vice-chairman of Citigroup and of Citibank, and he continues to serve Citi as a senior adviser.

Rhodes gained a reputation for international financial diplomacy in the 1980s for his leadership in helping manage the external debt crisis that involved developing nations and their creditors worldwide. He headed the advisory committees of international banks that negotiated debt-restructuring agreements for Argentina, Brazil, Mexico, Peru and Uruguay. In 1998, when the Republic of Korea experienced liquidity problems, he chaired the international bank group that negotiated the extension of short-term debt of the Korean banking system. In 1999, he acted as global co-ordinator to help implement the maintenance of trade and interbank lines by foreign commercial banks to Brazil.

He has received decorations and honours including an honorary doctorate in humane letters from his alma mater Brown University, Chevalier and Officer of France's Legion of Honour, decorations from Korea, Brazil, Mexico, Argentina, Venezuela and Jamaica, and multiple awards from not-for-profit organizations in recognition of his contributions to international banking and finance.

Rhodes is the author of *Banker to the World* (2011), which was published for the first time this year in Latin America under the title *Banquero del Mundo*.

He also served as vice-chairman of the G30's steering committee that prepared the reports calling for reforms in banking governance.

No one was listening

Too few banks and too few official supervisors did just this during the period from 2004 to 2007 when a range of financial activities were unfolding that should have sounded alarm bells. The levels of leverage in some financial institutions were soaring, as were the levels of issuance of sub-prime mortgages and the complexities of ever-more-derivative financial instruments. The attraction of making quick profits blinded some people to the unfolding and rising risks. The success over many previous years of the American financial system had made too many supervisors complacent about the system's eroding health.

The fact that the warnings were largely ignored ought to be a lesson bankers and supervisors should reflect upon. Over the years, I have, at times used opportunities to speak at the annual meetings of the Inter-American Development Bank to highlight prospective difficulties in the financial system. In the spring of 1997, I warned at its annual meeting in Barcelona that Asia's financial situation was heading for difficulties, which The Financial Times reported on its front page. Indeed, it was only a few months later that problems in Thailand triggered the Asian financial crisis.

In April 2006, at the IDB's annual meeting in Belo Horizonte, Brazil, I stressed that the days of easy money were coming to an end. The Financial Times quoted me as warning: "We are in a situation similar to that which existed in the spring of 1997 when threats existed to market stability and a lot of people didn't want to see it." Concerned about the complacency, I wrote an article for The Financial Times on March 29, 2007, under the headline A Market Correction is Coming. This Time for Real. I argued that pockets of excess were becoming harder to ignore and stressed the risks, in particular, in the sub-prime US mortgage market. I added: "This is clearly the time to exercise greater prudence in lending and to resist any temptation to relax standards."

Most of the banking community did not believe a correction was coming in the near future. It was clear a few months later, and it remains the case today that financial institutions need to do a much better job of risk management and corporate governance. They need to learn, for example, from the "Windows at Risk" approach where we not only saw problems arising, but ensured that they led to actions that reduced risk. But if the bankers were not listening to warnings of mounting difficulties, neither were the regulators and the super- visors. The financial community needs sound, smart and realistic regulation that is implemented on a continual basis to ensure risks are managed well, yet innovation is not stifled.

The critical role of reputational risk

The financial crisis exposed weaknesses in each of the four major areas of risk: credit risk, market risk, operational risk and reputational risk. The latter area has been the least discussed since the crisis, yet I believe it is of great importance. A bank's reputation is its most valuable asset. Failures to manage reputational risk can result in existential threats to an institution as it loses the trust of its employees,

shareholders, customers, business partners and regulators.

This issue has recently been attracting more attention because of the publication of two reports, based on extensive surveys and research, published by the Group of Thirty

G30), an international forum of public and private sector financial leaders, which called for far- reaching reforms in banking governance. These studies ranged right across the critical areas of risk management and culminated in the proposal that there needs to be a paradigm shift in relationships between official banking supervisors on the one side and the boards of directors and top managements of banks on the other.

The G30 published two reports: first, in April, 2012, it published Toward Effective Governance of Financial Institutions and, in October 2013, it followed up with A New Paradigm: Financial Institutions Boards and Supervisors.

In the first of these G30 reports, it was argued that building confidence and stability in the global financial system requires far-reaching governance reforms that are collaboratively embraced by boards of directors, firm managements, regulators and supervisors, as well as long-term share- holders. One of the core points the report made was that boards and management teams needed to be more sensitive to how they are perceived by their business partners and employees, which means that the tone at the top is important. This must influence the corporate culture, which dictates the institution's values and the behaviours of its employees.

Key recommendation

The report was based on an examination of governance arrangements at 36 of the world's largest financial services firms, interviews with leaders of these institutions, as well as regulators and supervisors. A key recommendation was a call on management to strengthen the fabric of checks and balances in their organizations. We argued that the board and management need to reinforce the values that drive good behaviour through the organization.

I stated publicly at the time of the report's publication, and subsequently to a meeting of the Financial Stability Board (FSB), that the board's crucial task is to ensure that the firm takes every step possible to protect against potentially fatal risks. While boards should not try to manage firms, they need to be unstinting – more so in the future than many have been in the past – in their concern for reputational risk. Boards and manage- ment need to champion an appropriate culture within the business and vigorously discuss all strategic proposals, key risk policies and major operational issues.

The FSB, the premiere international financial regulatory body, considered the report and encouraged the G30 to continue its work and this was the genesis of the second report, published in 2013. I have long argued – and this is a point stressed in the G30's New Paradigm report – that a deficiency or failure of culture including reputational risk can be as destabilizing to an institution as problems of capital or liquidity. The risk management failures in the last financial crisis severely damaged public trust. It is not

clear whether trust has been restored significantly and whether the industry has given enough attention to this matter.

As fresh allegations of wrongdoing have hit the headlines, so this distrust has created cynicism about financial institutions' capacity to change on a voluntary basis. Inevitably, the pressure mounts on governments, central banks and banking authorities to impose new measures that, in effect, could do their own damage to the financial sector.

Given this critical situation, it is not only imperative for organizations to strengthen their internal processes to improve their overall risk management, but that they, at the same time, take a far more pro-active approach to reputational risk. Considering culture together

with governance and business strategy is an essential part of forward-looking supervision.

Culture Matters

Issues of culture and risk are "soft" and correspondingly hard to deal with, and that has too often been seen as reason enough to set these matters aside. In the G30 report, it was concluded that greater attention needs to be paid to reforming culture in many institutions. Every bank has its own culture. Boards and supervisors must better understand cultural factors in effective governance and they need to institute regular mechanisms for measuring cultural performance.

Measurement is difficult, because culture is about behaviour. However, an important start, as highlighted in the recommendations by the G30, is to ensure that official supervisors and bank boards find ways to engage more in meaningful discussions on these issues. There is no simple formula and every institution develops its own unique culture. The perspectives of supervisors, who see many institutions, can be helpful, without them seeking in any manner to impose a specific cultural template on the board of directors. The G30 group did not believe supervisors and policy- makers should seek to write rules or guidance about culture, but they should set realistic expectations about what can be achieved.

A culture that places too great an emphasis on short-term profit-maximization and risk is one that can damage the financial strengths and the reputation of the bank – and once a reputation is lost, it is very difficult to restore it. The New Paradigm underscored the fact that boards should identify and deal seriously with potential cultural problems, make sure their compensation system in practice and provides the incentives that support the desired culture and monitor risk culture.

How to understand risk

Understanding risk is at the very core of corporate governance and management in every business organization. In banking, it tends to be more complicated than in most other business sectors. The complexity is mounting because of the globalization of the finance industry and the multiplicity of new, and often sophisticated, products. New technology has accelerated the pace of almost all forms of financial transactions and that adds significant pressures to risk management.

I have long taken the view, reinforced by working on the "Windows on Risk" system, that if a risk is too complicated to understand, it is too complicated to accept.

Effectively balancing risk, return and resilience takes judgement and establishing sophisticated risk management systems that strive, in a matrix format, to evaluate on a continuous basis the many forms of risk, is an essential component of sound risk management practice. It needs to be developed alongside heightened focus by boards of directors on the many facets of risk and the willingness of boards to engage with senior management on issues that may appear to be overly complicated and, thus, potentially too risky.

Values and culture are the ultimate "soft- ware" that determines the behaviours of people throughout the financial industry and the effectiveness of the industry's governance arrangements. Trust and integrity need to be seen as being at the very centre of the system.

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