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Without prudence as a value we are all at risk

Financial groups are dialling up risk in their search for yield because of the extraordinary amounts of liquidity created by central banks and the prolonged low-rate environment. This is often not being done prudently. The key causes of past financial crises are being forgotten at many financial institutions.

Senior managers and boards at such institutions need to put more emphasis on risk management and risk culture; some may not do so. Regulators and supervisors, for their part, should also press financial companies to focus more directly on risk-management culture and institute changes in this area. Their ability to do this may be compromised by their focus on the quantitative issues of capital and liquidity, frequently at the expense of the no-less-important qualitative matter of risk culture and behaviour.

New examples of imprudent risk behaviour arise almost daily. The Financial Times has noted the rapid rise of subprime lending in the US to finance used car purchases by non-creditworthy customers. Another warning signal was a statement by the Bank for International Settlements that 40 per cent of syndicated loans were now to subinvestment-grade borrowers, a greater ratio than in 2007.

Soaraway values

More broadly, the valuation gains seen in the equity markets, the prime real estate markets and at the leading art auctions bear little relationship to fundamental economic developments. These asset values are soaring, while world trade is stagnating. There is scant real growth across most of the eurozone and in Japan. US growth over the past 12 months has been less than 2 per cent, yet in the same period the S&P 500 stock market index gained about 17 per cent.

In the same vein, corporate emerging market debt has expanded by close to five times since 2008. This is far in excess of the real growth of emerging market economies, some of which are performing poorly and are more vulnerable to any future changes in monetary policies.

While China's economy does appear to be growing in line with the government's objective of 7.5 per cent, this is in large part a result of increased levels of credit growth. As a result bubbles are surfacing in the hot property markets. The shadow banking system is also expanding rapidly and is only lightly regulated, while mainstream banks continue to maintain high lending levels to state-owned enterprises and municipalities.

On a global basis, managers of some financial groups are not sufficiently curbing imprudent risk-taking. To some degree they feel the competitive pressures to produce better quarterly results consistently. At the same time many management and board risk committees are still not properly equipped to oversee risk management and to change the prevailing culture. Another serious concern is that in the eurozone the European Central Bank will be focusing on capital, liquidity and other metrics, while paying insufficient attention to risk behaviour, as it conducts stress tests of large banks.

UK and US authorities, meanwhile, are increasingly concerned about specific issues of banking misconduct. These are serious to be sure, but there is insufficient focus on the broader issues related to the current reach for yield that could pose future systemic threats.

Fed must lead

The US Federal Reserve has a crucial role here. Richard Fisher, president of the Dallas Federal Reserve Bank, said in a speech last month: "I believe we are experiencing financial excess that is of our own making. When money is dirt cheap and ubiquitous, it is in the nature of financial operators to reach for yield."

Mr Fisher is right, and the Fed should use its powers to press the leaders of US banks to promote prudence in risk taking as a core cultural value. Given that about 75 per cent of the US capital market is in the hands of non-bank institutions, it is important that the Securities and Exchange Commission and the Commodity Futures Trading Commission join the Fed in publicly (and privately) calling for proper risk behaviour.

Jointly, leaders of financial institutions and their regulators in the US, UK, Japan, the eurozone and in China, should emphasise the importance of risk management and risk culture. They should come together to exchange views candidly and explore ways to channel risk activities on to a surer course.

There are no simple remedies, and changing culture in institutions always poses difficult challenges. But it is vital that actions are taken, before a financial crisis materialises, to recognise that proper risk behaviour truly matters to the safety and soundness of the financial system.

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