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A Call for Strategic Risk Management

Risk management is getting a lot of attention these days. Actually, it has been getting a lot of attention for the better part of a year, as any person involved with running, regulating, or investing in financial institutions can attest in light of the colossal, unprecedented, and transformational events gripping our credit and financial markets on a global scale.

In the 2005 film by Cameron Crowe, *Elizabethtown*, shoe designer Drew Baylor has just lost his company nearly one billion dollars. Losses of such magnitude, especially if resulting from the short-sightedness of individuals rather than institutions, tend to prompt philosophical responses. Mr. Baylor makes the following distinction between failure and fiasco: “There's a difference between a failure and a fiasco. A failure is merely the absence of success. Any fool can achieve failure. But a fiasco, a fiasco is a disaster of epic proportions. A fiasco is a folk tale told to others to make other people feel more alive because it didn't happen to them.”

Who could or would deny that what is unfolding in our capital markets, our credit markets, our financial markets is at the level of fiasco, failure to the nth degree (“nth” because we are still looking for bottom, the point at which stability and confidence once again return) that affects us all? While we try to find our way through and out of this terrible morass, many important questions are being raised and have been raised about risk management, specifically the practice of risk management in our financial institutions. Make no mistake, we will have to find a way to better manage, respond and prepare for risk if we are to have a viable, vibrant, and sustainable financial services sector now and in the future.

In a recent speech, Federal Reserve Governor Randall Kroszner made a compelling case for the importance of strategic risk management in financial institutions.¹ From the point of view of a risk management practitioner, perhaps even a senior bank officer or board member, *strategic* risk management during these very uncertain times has a very reassuring ring to it. Risk management is the process or function that was supposed to forewarn and illuminate the implicit and not so implicit hazards of various lending, investment, asset deployment, and funding strategies that have been the bread and butter of financial institutions over the last decade or more. Clearly, something failed in these systems for such a “disaster of epic proportions” (read fiasco) to have materialized literally over the past year. Mr. Kroszner outlines key components of a responsible and responsive strategic risk management framework that financial institutions are well advised to consider.

Mr. Kroszner describes strategic risk management as:

“...an effective overall corporate strategy [combining] a set of activities a firm plans to undertake *with an adequate assessment of the risks included in those activities*...In other words, there can be no real strategic management in financial services without risk management, hence my use of the term ‘strategic risk management.’ *Risk management needs to be interwoven into all aspects of the firm’s business and should be part of the calculus of all decision-making.* Strategic decisions about what activities to undertake should not be made unless senior management understands the risks involved; assessing potential returns without fully assessing the corresponding risks to the organization is incomplete, and potentially hazardous, strategic analysis.” [Emphasis added]

Mr. Kroszner correlates the shortcomings of existing, essentially non-strategic risk management practices with the current meltdown and resulting costly bailout of our credit and financial markets. The clear implication is that had financial institutions done a better job of executing risk management practices integrated with strategy, the current crisis in our financial markets may have been averted. In the October speech, he cites funding and liquidity, as well as compensation structures and incentives, in prime examples of how the practice of strategic risk management could impact favorably the ways in which financial institutions do business.

Meeting funding and liquidity requirements is central to the business of banking. As intermediaries transforming liquid deposits into illiquid loans and other earning assets, banks have always faced the challenge of managing funding and liquidity needs in a value-added and sustainable fashion. We are witnessing in the current crisis a breakdown in that very process of intermediation, resulting in frozen credit and capital markets. Instead of being concerned primarily with “building market share, growing revenues, and realizing the short-term profitability of their activities,” Mr. Kroszner believes that banks are better served by building and implementing strong strategic risk management frameworks that properly assess funding and liquidity risk on both sides of the balance sheet. Such proactive risk management would include stress testing and the development of sound contingency plans, aspects of “better practice” liquidity risk management as cited by the recently released *Principles for Sound Liquidity Risk Management and Supervision* report by the Basel Committee on Banking Supervision.²

Mr. Kroszner cites compensation as a factor in the short-sighted business decisions that have contributed to the present market dislocation. He makes a compelling case for the importance of linking compensation and risk management. As investors, we are advised to consider asset returns on a risk-adjusted basis when deciding what investments to hold or to sell. According to Mr. Kroszner, “management at financial firms should do the same thing with regard to their business units and their employees.” “Short-term and one-sided incentives” should be replaced more kinds of deferred compensation “since the risks of certain investments or trades may not manifest themselves in the near term.”

There are tremendous opportunities on the other side of this transformational process underway in our financial services sector. When the dust settles for sure, remaining institutions will have to operate in a business environment leaner and far less forgiving. Financial institutions that proactively and effectively combine strategy with risk management surely will outperform and outlast those who do not.

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¹ Randall S. Kroszner: *Strategic Risk Management in an Interconnected World*, speech by Mr. Randall S. Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the Risk Management Association Annual Risk Management Conference, Baltimore, Maryland, October 20, 2008.

<http://www.federalreserve.gov/newsevents/speech/kroszner20081020a.htm>

² Basel Committee on Banking Supervision, *Principles for Sound Liquidity Risk Management and Supervision*, September 2008. <http://www.bis.org/publ/bcbs144.htm>