The Role of Poor Risk Management in the Crisis

Financial Crisis Inquiry Commission

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- Background: Universal Agreement except on the details

- Two opportunities for the Commission
  - Reports on spectacular collapses
  - Data disclosure on basic practices

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Every observer points to poor risk-management as a contributing factor in the crisis

Examples: GAO http://www.gao.gov/new.items/d09499t.pdf

- We reviewed one regulator's tracking report of matters requiring attention at one institution and found that only a small number of the 64 matters requiring attention relating to risk management and internal controls had been closed out or considered addressed by the end of January 2009

Senior Financial Supervisors from Seven Countries

http://www.newyorkfed.org/newsevents/news/banking/2009/SSG_report.pdf

- Many firms acknowledged that, if robust funds transfer pricing practices had been in place earlier, they would not have carried on their trading books the significant levels of illiquid assets that ultimately led to large losses and would not have built up significant contingency liquidity risks associated with off-balance-sheet exposures.

More blame regarding risk management problems

Ben Bernanke http://www.federalreserve.gov/newsevents/speech/bernanke20090507a.htm

- The crisis exposed the inadequacy of the risk-management systems of many financial institutions. We have stepped up our efforts to work with banks to improve their risk-identification practices. For instance, we have emphasized to banks the importance of stress testing to help detect risks not identified by more-typical statistical models, such as abnormally large market moves, evaporation of liquidity, prolonged periods of market distress, or structural changes in markets.

Barney Frank http://www.house.gov/frank/speeches/2009/07-27-09-national-press-club.pdf

- The problem with executive compensation is essentially from the systemic standpoint, that it gives perverse incentives. That if you are a top decision maker, or maybe even somebody else down the chain, you may have a system in which you are incentivized to take a risk because if the risk pays off, you make money. And if the risk doesn't pay off, you suffer no penalty. Heads you win, tails you break even.

Why did risk management fail?

1. Bad incentives for the CROs?
   – Compensation problems for the CRO

2. Conflicts within the organization?
   – Compensation problems elsewhere or oversight failures

3. Modeling mistakes?
   – Poor methodology

How can the FCIC help?

- Adopt the NTSB approach to writing definitive reports on the biggest accidents: GMAC Finance, Fannie Mae, Freddie Mac, Countrywide Financial, Washington Mutual, Wachovia, Bear Stearns, Lehman, and AIG
- **UBS Report to Shareholders should be the model**
- Qualitative information should include
  - What were the biggest mistakes?
  - How were differences of opinion mediated?
  - Rotation policies and career paths for risk managers

Additional basic data collection and dissemination

Study the systemic firms: 19 banks that were included in the Federal Reserve's Supervisory Capital Assessment Program, plus GMAC Finance, Fannie Mae, Freddie Mac, Countrywide Financial, Washington Mutual, Wachovia, Bear Stearns, Lehman, Merrill Lynch, and AIG

Data needed

1. CRO total compensation and compensation break-down
2. A detailed organization chart of risk management
3. Describe executive officer (EO) monitoring of the derivative trading desks
4. Comparison of trader compensation and EO's compensation
5. Policy on the role of options in CRO compensation.
6. Director assignment policies for serving on the Risk Management Committee
7. Stress test frequency and methodology
8. Liquidity risk methodology