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Creating a new foundation for risk management

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The Chicago Fed's Supervision and Regulation Department, in conjunction with DePaul University's Center for Financial Services, sponsored its fourth annual Financial Institution Risk Management Conference on April 11–12, 2011. In addition to discussions about risk management, this year's conference focused on the impact of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act).

Materials presented at the conference are available at www.chicagofed.org/webpages/events/2011/risk_conference.cfm.

Conference discussions also centered on the new face of mortgage finance and the management of incentive compensation and the associated regulatory guidance, along with the impact of new capital rules, which are expected to be influenced by the Basel Committee on Banking Supervision guidelines for strengthening the banking sector's resilience (known as Basel III). This *Chicago Fed Letter* provides a summary of the presentations and discussions of the regulators, academics, risk-management professionals, and business leaders who participated.

Ali Fatemi, alumni professor and chair, DePaul University, and Carl R. Tannenbaum, senior vice president, Federal Reserve Bank of Chicago, opened the conference. Fatemi noted that, as in the past, this year's meeting would provide for timely, illuminating, and informative discussions. Tannenbaum pointed out that we are in the "middle stages" of improving risk management, including the supervision of bank holding companies. Many lessons have been learned from the recent financial crisis. The Dodd–Frank Act was legislated in an attempt to address some deficiencies that became evident during the crisis, including certain nonbanks not being subject to regulations and loan underwriters not retaining sufficient "skin in the game." However, not all observers agree that such efforts will have the desired effect of making the financial system more resilient to financial shocks and crises. Although improved governance and increased levels of capital may assist in strengthening financial institutions, much of the architecture of the current banking system still needs to be reviewed and evaluated—and perhaps improved upon. There is an expectation that a stronger banking system will emerge in the "later stages" of improving risk management, said Tannenbaum.

Views on the recession and the banking sector

Charles L. Evans, president and CEO, Federal Reserve Bank of Chicago, noted that recent data suggest growth has picked up, indicating a moderate economic expansion, despite factors such as residential and commercial real estate markets not growing, unemployment still remaining high, and state spending levels being down. At the January Federal Open Market Committee meeting, gross domestic product (GDP) growth in the range of 3.5% to 4% was forecasted for 2011. Although any growth is welcomed, such growth, by historical standards, constitutes a moderate recovery, said Evans, and unemployment remains at 8.8%. Certain market segments are still

depressed, such as residential investment and single-family housing starts; and new home sales are at historic lows. Many distressed and foreclosed properties still have not been put on the market. Evans noted that mortgage reform may be a lengthy process. Sales of new mortgage-backed securities issues have been anemic, and many questions remain as to what role government will play in the mortgage market in the future.

Shifting to the health of the banking sector, Evans stated that many banks have completed balance sheet repairs and, although earnings have not fully recovered, recent capital analysis shows bank health has improved. Still, bank managers remain cautious while questions—such as what is the appropriate level of capital for systemically important financial institutions (SIFIs) and what should be the form of that capital—continue to be debated.

In conclusion, Evans noted that as we slowly emerge from the worst financial crisis since the 1930s, government and regulators are heavily involved in making changes through the Dodd–Frank Act and the potential implementation of Basel III. Macroprudential supervision implemented under the new legislation and guidelines will involve regulators monitoring and detecting risks across the financial system—not only at individual banks, as with traditional microprudential supervision.

CEO and chief risk officer perspectives

Richard C. Cahill, vice president, Federal Reserve Bank of New York, moderated a panel featuring a bank CEO and two bank chief risk officers discussing risk management. Cahill started the conversation by stating that regulatory reform, which has many implications for the financial institutions (especially SIFIs), and Basel III could have a significant effect on future lending.

Terry J. Bulger, chief risk officer, BMO Financial Group, explained that his organization promotes an approach to risk management that utilizes three lines of defense. The first line is business units being responsible for their own risk; the second line comprises the risk-management group together with other corporate groups; and the third line is provided by corporate audit. These three lines of defense, along with other strategies, such as working with business units to embed a strong risk culture, help BMO to achieve excellence in risk management.

> Creating a new foundation for risk management will involve thinking about the interrelated nature of risks, the risk-management process, and practical application of risk resolution strategies.

Leonard E. Wiatr, chief risk officer, PrivateBancorp Inc., shared his risk-management philosophy, which is to build a robust risk-management infrastructure designed to integrate, coordinate, and facilitate proactive risk-management practices throughout the enterprise. Wiatr said he also adheres to a similar three-lines-of-defense approach when it comes to risk management. In addition, Wiatr noted he has a business risk committee providing oversight over the three lines. He contended that the board of directors' and senior executive management's support of the risk-management function's efforts was essential to effectuate change within an organization.

Philip B. Flynn, president and CEO, Associated Banc-Corp, presented the story of his $22 billion financial organization, headquartered in Green Bay, Wisconsin—a community bank that had a long history of outperforming others. As his organization grew into a regional bank, it outgrew its original risk-management structure and did not replace it with one that was appropriate. One consequence of this was heavy involvement with commercial real estate, which was outside the comfort zone of the organization. As a result, aggressive and appropriate actions were needed to reduce credit risk, including taking significant credit-related charges. A change in management, early loss recognition, and a significant raising of capital preceded the organization's return to profitability in the second half of 2010. During that time, management also focused on enhancing corporate governance, adopting a risk appetite definition and a portfolio management approach, and implementing an enterprise risk-management framework.

Cathy Lemieux, executive vice president, Federal Reserve Bank of Chicago, asked the panel members what their organizations have done to make a cultural shift in terms of risk management; in response, the panelists mentioned it is important to bring in new people with a different perspective to challenge the status quo.

Corporate governance

Sarah J. Dahlgren, executive vice president, Federal Reserve Bank of New York, discussed corporate governance and why it matters. Dahlgren noted that with strong corporate governance, problem areas are often identified earlier. Weak governance practices are thought to have been a key contributor to the financial crisis, especially when those in charge had no idea of their organizations' vulnerabilities. Dahlgren acknowledged that risk management was not always a regulatory focus; rather, the focus was on internal controls over various processes to mitigate risk. However, companies' internal controls did not usually address emerging risks. Dahlgren said that going forward it is expected that the risk-management function will be better heard by those at the top of an organization. She also argued that a key feature of establishing and maintaining good corporate governance is to have the tone set by those at the top with an engaged board of directors.

Impact of Dodd–Frank Act

Kathleen M. Cronin, managing director, CME Group, moderated a panel on the impact of the Dodd–Frank Act, which had been in effect for nine months at the time of the conference. When thinking about the act, she said three words came to mind: "mired in uncertainty." Because of the breadth of the act, it is unclear when this uncertainty will go away, she said.

Richard Spillenkothen, recently retired director, Deloitte & Touche LLP, stated that the Dodd–Frank Act is expected to significantly decrease the risk of a crisis-prone environment with the macro-prudential supervisory focus and new tools, such as the Financial Stability Oversight Council, to assist regulators in identifying systemic risk indicators. However, the act's sheer volume may cause unintended consequences because so many changes are happening at the same time, noted Spillenkothen. Peter J. Wallison, an Arthur F. Burns Fellow, American Enterprise Institute for Public Policy Research, provided another view on the act. Wallison said he opposed the act when it was formulated because to him, the financial crisis did not come about from insufficient regulatory practices or regulations, but from poorly designed mortgage policies and practices.

Kristin Odeh, senior vice president, Northern Trust, represented a corporate risk-management practitioner's view of the Dodd–Frank Act. For the act's implementation to be ultimately successful at an organization, she said, there needs to be strong sponsorship, a narrow scale, well-defined requirements, a measured pace, existing market solutions, and available expertise. Initially, the scale for reform was too broad, the requirements were unclear, the pace was too fast, and the expertise was unavailable. Some of those assessments still apply today except that the requirements have become better defined and expertise in this area is developing. Odeh shared some near-term steps for effectively implementing the act—such as establishing a high-level office to manage that implementation (sponsorship); setting up a legislative response program to monitor the rule-making process and doing a high-level impact assessment to determine what portions of the act will affect the organization (requirements); understanding critical path timelines (pace); and hiring experts if leaders of an organization need to think more broadly or differently about the full impact of the act on their firm (expertise).

Lastly, Odeh provided some overarching suggestions: Understand where your high risks are and prioritize your efforts to focus specifically on those risks; implement a corporate governance model that fits your organization's culture; and finally, get started—do not wait to create a plan, communicate it with others, measure its success, and build the team to engage the employees of the organization.

New face of mortgage finance

A panel, moderated by Tannenbaum, discussed new developments in mortgage finance; it consisted of Anne C. Canfield, president, Canfield & Associates Inc.; Alex J. Pollock, resident fellow, American Enterprise Institute for Public Policy Research; and Sarah Bloom Raskin, Governor, Board of Governors of the Federal Reserve System. Canfield identified headwinds to improvements in the mortgage financing arena—the most prominent being a poor market environment, with 5 million seriously delinquent single-family mortgages in the U.S., a "shadow" inventory (i.e., homes in the process of foreclosure) that keeps on growing, and home prices that continue to decline.

Raskin said that at present the private mortgage market is essentially not functioning, with 88% of mortgages being funded or insured by government-sponsored enterprises, roughly double the level over the period 2000–07. So, it is hard to imagine the private mortgage market reviving anytime soon. Pollock stated that some government-sponsored enterprises (e.g., Federal Home Loan Bank Board and Fannie Mae and Freddie Mac) have collapsed previously; he argued that the solution is to move toward greater privatization and that credit risk needs to be better connected to credit underwriting.

Pollock stated that the U.S. is ranked 17 out of 25 in homeownership among industrialized nations, so we should not tout the mission of Fannie Mae and Freddie Mac as the best in the world. Responding to a question asking whether there are other financial lending models in the world that the U.S. should emulate, he did not endorse an alternative model to follow. Rather, he acknowledged that we may well have to pick the best features from other countries' systems.

CEO perspective on risk

David W. Nelms, chairman and CEO, Discover Financial Services, used the Rubik's cube as an analogy to discuss his perspective on risk management. Risk management is not done until each of its sides is a solid color, Nelms explained, meaning that it is a multifaceted challenge with many different sides to be solved. He explained the six sides of the "risk-management cube," namely, culture (appropriately balancing risk with other objectives), capital (establishing strong capital, liquidity, accounting, and a well-constructed balance sheet), customers (maintaining outstanding service operations with the goal of minimal attrition), credit (using excellent data and models without taking out all of the human judgment), controls (setting up strong internal controls and following external regulations), and chiefs (hiring and developing experienced and strong leadership). Solving all six sides will lead to sounder risk management at a firm, according to Nelms.

Incentive compensation

James R. Booth, professor of finance, DePaul University, moderated a panel on incentive compensation, which consisted

Charles L. Evans, *President*; Daniel G. Sullivan, *Executive Vice President and Director of Research*; Spencer Krane, *Senior Vice President and Economic Advisor*; David Marshall, *Senior Vice President, financial markets group*; Daniel Aaronson, *Vice President, microeconomic policy research*; Jonas D. M. Fisher, *Vice President, macroeconomic policy research*; Richard Heckinger, *Assistant Vice President, markets team*; Anna L. Paulson, *Vice President, finance team*; William A. Testa, *Vice President, regional programs, and Economics Editor*; Helen O'D. Koshy and Han Y. Choi, *Editors*; Rita Molloy and Julia Baker, *Production Editors*; Sheila A. Mangler, *Editorial Assistant*.

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of Jennifer N. Carpenter, associate professor of finance, New York University; John K. Gayley, director, executive compensation practice, Towers Watson; and James W. Nelson, senior vice president, Federal Reserve Bank of Chicago.

Nelson stated that the regulatory focus is based on a view that poorly designed incentive compensation arrangements contributed to the financial crisis. Regulators have focused on the design of compensation, but Congress—through the Dodd–Frank Act—has focused on both the design and the level of compensation for firms with greater than $10 billion in assets.

Gayley stated that compensation is an integral part of the entire risk-management program, but not the most important. Excessive business risk can be mitigated through not only sound incentive compensation design but also solid goal setting and business alignment, sound corporate governance, and strong ongoing employee communication and education, among other means. He also mentioned potential red flags, such as steep incentive curves with no caps, which could be indicative of poorly designed incentive compensation arrangements.

Carpenter stated that risk incentives tied to compensation are the real problem for poor risk management and that excessive compensation is more of a symptom. Initially, there was a lot of focus on the level of compensation, but the concern now is how the level of compensation affects the risk incentives. She concluded that we need to control the risk incentives and also need to look at risk management holistically—across the risk disciplines.

Impact of new capital rules

David Marshall, senior vice president, Federal Reserve Bank of Chicago, moderated a panel on the impact of new capital rules, which featured George G. Kaufman, professor of economics and finance, Loyola University Chicago; Kevin M. Killips, chief financial officer, PrivateBancorp Inc.; and Marc R. Saidenberg, senior vice president, Federal Reserve Bank of New York.

Marshall gave a brief primer on Basel III. In addition to changes in the level of capital being put forth, Basel III seeks to add more loss-absorbing capital capacity for SIFIs through contingent capital forms and “bail-in” provisions, by which debt can be converted quickly to equity.

Killips anticipated that capital rules under the Dodd–Frank Act will start to match up with Basel III over the next five to six years. Clearly, banks expect to be required to hold more capital. Saidenberg stressed that one significant goal of Basel III is to promote resiliency in the banking sector. Kaufman answered the question of the Dodd–Frank Act’s impact with “Who knows?” His point was that there has been a long history of capital changes that were designed to improve the banking sector, and yet we are still in an environment where more change is considered necessary. According to Kaufman, the current system of calculating capital by the risk-weighting of assets, which seems like a good idea in theory, may not be effective in practice. He said that perhaps the focus should be on the leverage ratio, which is used in all other industries and by the market to provide a stronger constraint (than the risk-weighting of assets) on risk taking. Finally, he noted that current capital regulations are very complex and that for new regulations to be effective, they will need to be simplified.

Summing up

The recent financial crisis has played a large role in leading us to create a new foundation for risk management. The Dodd–Frank Act has mandated many new regulations that will influence the financial landscape and firms’ risk-management functions as well. As organizations emerge from the financial crisis, they should ensure that they will be better prepared the next time problems arise. It was clear from the various discussions that an organization establishes effective risk management with clear and consistent communication throughout the organization and with solid support from the top. Appropriate risk appetites and levels should be determined, controlled, and monitored during noncrisis times so that the risk-management processes are implemented before new challenges emerge.