Regulation, Supervision, and Risk Management of Financial Institutions

An OECD perspective

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The interlinked components of risk management

In finance, discipline always has to be imposed: if not by governance or the market, then by regulators and supervisors.
Risk is inherent to financial intermediation

Banks
- Lending
- Maturity transformation
  - => credit risk, liquidity risk, market risk
- Purpose
  - Match surplus of capital with demand
  - Facilitate real economic activity
  - Through coverage and proper management of risks

Securities firms
- Mark-to-market basis
- Short-term funding
  - => Funding and liquidity risks
- Purpose
  - Take on risks as long as the cost of doing so makes sense from the institution’s own point of view of its balance sheet (i.e. profit maximisation)
  - There may be little economic incentive to internalise costs associated with the protection of third parties or the system as a whole

Insurers
- Technical risks (under-pricing, under-provisioning)
- Investment risks
- Other risks
- Purpose
  - Errors of judgment, flawed business models (risks to safety and soundness)
  - Failures pose significant problems for customers and clients, especially individuals and SMEs (risks to clients)
  - Asset quality problems can lead banks to become reluctant to extend new loans or refuse requests for rollovers
  - Contagion (risks to the system)

What can go wrong?

Own goals vs. collective rationality
- Take on risks as long as the cost of doing so makes sense from the institution’s own point of view of its balance sheet (i.e. profit maximisation)
- There may be little economic incentive to internalise costs associated with the protection of third parties or the system as a whole

Some institutions will err in the process
- Errors of judgment, flawed business models (risks to safety and soundness)
- Failures pose significant problems for customers and clients, especially individuals and SMEs (risks to clients)
- Asset quality problems can lead banks to become reluctant to extend new loans or refuse requests for rollovers
- Contagion (risks to the system)
Feedback loops among mismanaged risks

- Direct losses (funds, assets, collateral)
- Loss of access to financing

Loss of confidence

- Maintaining confidence is necessary if the financial system is to attract capital and function efficiently
- On deposits, CIS, repos, market liquidity
- Broader system-wide problems

Failures

Runs

Crisis episodes can have longer run effects

The evolving crisis is illustrative

Crisis backdrop

- Imbalances on the macroeconomic front
- Flawed incentives across the range of market participants

Some core features of the crisis

- A substantial build-up of leverage and accumulations of assets, with very low risk spreads and high concentrations of risk (risk management?)
- Evolutions in risk mgt. processes, wider acceptance of instruments for credit risk transfer and structured products, underestimation of required liquidity (market discipline?)
- Insufficient pressure to adequately enforce proper underwriting and risk management criteria, allowing excess leverage to build-up in structured investment vehicles and conduits (supervision?)
Crisis outcomes are not so rare ...

...and the effects can be significant

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Notes: 1. Definitions differ across countries.
Enterprises by size class in 2007

OECD, Entrepreneurship at a Glance 2011

Employment by size class in 2007

OECD, Entrepreneurship at a Glance 2011
… and the costs have sometimes been high


What should be done?

- **High costs of widespread distress**: Prevention is better than cure, but how best to do it?

- **Limits of risk management**: Boom-and-bust cycles are recurrent phenomena. Systemic risks can hide in the interactions between institutions, products, and markets, and not necessarily with particular institutions.

- **Limits of market discipline**: Only as effective as the broader governance framework. Weak mgt. systems or ineffective or incompetent boards => cannot rely solely on firewalls and related control mechanisms to control or mitigate conflicts of interest or other risks.

- **Limits of supervision**: Difficult in practice to directly control behaviour without sacrificing some measure of efficiency and innovation or creating adverse incentive effects.
What about structure?

![Graphs showing total assets of largest 3 banks as share of GDP.

Balance sheets of large financial groups

- More risky elements but more diversification
  - Large, integrated institutions may not have a greater risk of failure than smaller institutions
  - Might fare better because of the diversity of their activities or the diversity of their funding sources

- But risk factors can interact
  - Increases in cross-sector, cross-border, or cross-risk type correlations limit diversification benefits
  - If not properly managed, these risk exposures can precipitate institutional failures or have broader implications
  - And given cross-sector and cross-border inter-linkages, once problems do erupt they tend to be transferred from one market segment or region to another
The structure-behaviour nexus

Regulate Structure
Some activities not compatible from a direct risk or moral hazard standpoint
Should not be combined

Regulate Behaviour
Issue is not structure per se
But implications of structure for risk management & internal controls

Would the separation of traditional and non-traditional bank business make the sector safer?

Opaque universal banking model vs. Non-operating holding company structure, with firewalls

### Linked components of risk management

**Structure alone not sufficient**
- Possible risk of contagion across group members from shared brand name and damage to group’s reputation
- Entire governance framework must be appropriate for risk profile and business model

**Role of managers in risk mgt.**
- Direct, but not sole, responsibility for ensuring a proper mix and mgt. of institution’s assets and liabilities

**Effective market discipline**
- Should provide an external constraint on managerial discretion
- External governance mechanisms are at a disadvantage in the case of complex structures

**Normal competitive mkt. function**
- Some institution’s asset-liability mix, risk mgt. techniques, or entire business model will prove to be deficient and result in losses or failure

**Implications**
- Is the problem idiosyncratic, likely to spread to other institutions having a similar structure or business model, or further still?

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**Thanks very much for your attention**

**Any questions?**