Problems and opinions

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CREDIBILITY VS. RISK IN CONTEMPORARY CREDIT INSTITUTIONS IN THE CONTEXT OF THE SAFETY NET SOLUTIONS

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A credit institution is a unique element of business landscape. On the one hand, a bank acts and performs activities on its own account, on the other – its activities affect the entire financial system. If anything fails in its own commercial performance (forgetting for a while the cause of the failure), it influences both other credit institutions, and many organizations that operate in the financial system to fulfill the sector's effectiveness and above all safety. That impact can be pertinent to other segments of economy as well as can have repercussions on cross-border scale. In literature hypotheses are formulated about the lack of adequacy between present solutions in the financial services market security and the scope of potential dangers that result from transsectoral and cross-border integration (Cf. P. Artus, Financial intermediation and transfers of default risks: macro- and microeconomic efficiency, in: The New Banking Economics, ed. by O. Pastre, E. Jeffers, H. Blommestein, G. de Pontbriand, Edward Elgar, Cheltenham – Northhampton 2007; M. Iwanicz-Drozdowska, Bezpieczeństwo usług finansowych. Perspektywa Unii Europejskiej, SGH w Warszawie, Warszawa 2008).

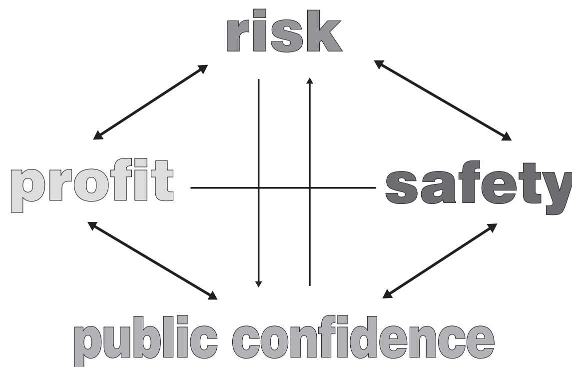
This paradigm contains a particular reference to macro-responsibilities of a contemporary credit institution. Differing from a micro-responsibility that can be defined as striving at such a functioning due to which business goals are achieved in the best possible manner, macro-responsibility means an effective, efficient and safe performance within the net created by other credit institutions and organizations that exist in the banking system. Micro-responsibility calls for attention paid to commercial measures and indices such as sales growth dynamics, market share, shareholder's value increase, etc. Many authors also point out in this respect the importance of the corporate governance. Hence, the questions of the role of minority shareholders, full disclosure and transparency, prudent risk management and the role of the board of directors, is undergoing a thorough discussion (Recent Financial Crises. Analysis, Challenges and Implications, ed. by L. R. Klein and T. Shabbir, Edward Elgar, Cheltenham – Northhampton 2006). On the other hand, macro-responsibility concentrates on the specific role of banks in the economy. Consequently, both systemic results of an individual failure, and its cost for the economy have to be taken into account.

Both types of a responsibility overlap with each other and their differentiation in this paper not necessarily corresponds with practical demand if banking managers in boards and committees act in an effective, efficient, and safe manner. However, at least three points can be risen as a proof for a somewhat different situation. Firstly, crises in banking systems, including the one of 2007. Secondly, conferences devoted to real problems of the banking sector, like this one organized by the Polish Banking Guarantee Fund. And thirdly, opinions already voiced and planned to be formulated during such meetings and conferences (e.g. L. Pawłowicz, Kto zapłaci za kryzys bankowy na europejskim rynku finansowym? Propozycje rozwiązań, Warszawa 2007).

It becomes crucially important to properly identify the role and scope of responsibilities of various institutions of the financial system, like the central bank, financial supervisory boards, rating agencies, credit agencies, and guarantee funds, etc., when facing real instability having its internal or external origin. The significance of debate (and of solutions) concerning the safety net respectively increases. Within or without the framework of such a net, however inside institutions and agencies which are supposed to be its elements, since mid 2007 a thorough observation of the subprime problem in the American financial system is taking place. In Poland and in neighbouring countries discussion on a possibility of occurrence of second- or third-round effects of American problems has been risen up on many occasions. And though there was no real danger of a direct impact of the crisis on credit institutions being active in Poland it is still very comforting to be able to read comments like that one of J. Wancer's (SE, September 8, 2008) about a hurricane that missed our heads leaving however few clouds over Poland.

The debate on real or unreal dangers for activities of a modern credit institution should start nevertheless with the problem of micro-responsibility. The trade-off between crucial notions of risk, credibility, and public confidence, on the one hand, and financial results, on the other, is inseparably connected with banks' commercial activities and its expansion. The nature of relationships between those fundamental notions is shown in Figure 1.

Figure 1. Trade-offs in banking



It is important to examine trade-offs inside a contemporary firm. We have been knowing since ages that all the notions are very important and have to co-exist in reasonable proportions but… the world is changing. Additionally, practical consequences of adopted solutions are very important inside a credit institution but at the same time they radiate at the environment causing consequences for the entire financial system (on risk and the position of banks in society see essays of G. de Pontbriand, Long live risk!, and of D. Plihon, When banks transfer risks to investors, in: The New Banking Economics, ed. by O. Pastre, E. Jeffers, H. Blommestein, G. de Pontbriand, Edward Elgar, Cheltenham – Northhampton 2007). This observation have been valid especially in past few decades when changes in the intermediation world caused rearrangements both in the set-up of credit institutions and in their surroundings i.e. among their competitors and in the official sector. Those changes opened the banking sector to a lot of unorthodox instruments and untypical phenomena. Globalization additionally widened the margin for the "evil". In her book on Fragile Finance, A. Nesvetailova (London 2007, Palgrave/Macmillan) confronts three notions: debt, speculation, and… crisis, typical for the age of global credit. And Arnone and Gambini add: "Over the past three decades the financial landscape has been radically transformed by three

main driving forces: globalization, liberalization, and technical innovation. This has resulted in heightened capital market integration, and in a greater role in resource allocation for the financial sector than before. The growing role and size of the financial sector has generated advantages such as a broader, cheaper and more accessible range of financial services, wider distribution channels, and higher efficiency in terms of resource allocation. However, these benefits have not come without cost. The experience of the past decades provides good evidence that moving from a tightly controlled financial system to a much more competitive one has exposed the banking system to an increased risk of a systemic failure and has been associated with frequent and costly periods of financial turmoil" (See: M. Arnone, A. Gambini, Architecture of Supervisory Authorities and Banking Supervision, in: Designing Financial Supervision Institutions. Independence, Accountability and Governance, ed. by D. Masciandaro, M. Quintyn, Edward Elgar, Cheltenham – Northhampton 2007).

Inevitably, faced with dramatically deep changes in the banking sector and with real and potential dangers of financial breakdown, one has to resort to untypical and even outdated rescue measures. *There is even an appropriate saying in Polish: a drowning man catches the razor knife…* The recent nationalization of Freddie Mac and Fannie Mae may serve as an example. Billions of dollars and pounds flowing from tax-payers pockets to treasuries of market giants deemed to be Too Big To Fail show the border-line of intervention of a modern state on the marketplace which no longer is a market that can function flawlessly at no cost. Simultaneously, international repercussions of the recent financial market turbulence show how important it is to contemplate some safety net arrangements on a larger scale. The benign risk environment some international banks used to enjoy before the crisis of 2007 can hardly be duplicated in the future[1]. The debate on systemic solutions concerning the safety net is bothering bankers not only during this conference but it is hard to conclude that general and practical global or European solutions have been clearly defined and accepted. Some regulatory initiative has been however shown and is waiting for further discussion and – keeping the fingers crossed – implementation.

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[1] As a risk manager at a large global bank explained: "(…) It was hard to see where the problems would come from. Four years of falling credit spreads, low interest rates, virtually no defaults in our loan portfolio and historically low volatility levels: it was the most benign risk environment we had seen in 20 years. (…) was always a topic high on our list but we could only see more liquidity coming into the market–not going out of it. Institutional investors, hedge funds, private-equity firms and sovereign-wealth funds were all looking to invest in assets. This was why credit spreads were narrowing, especially in emerging markets, and debt-to-earnings ratios on private-equity financings were increasing. "Where is the liquidity crisis supposed to come from?" somebody asked in the meeting. No one could give a good answer." (The Economist, Aug 7th 2008).

However, before the cross-border initiative will materialize there is certain space for interim solutions. And no wonder, such solutions have to concentrate on best practices within the sector. Once again, a credit institution needs to reconsider its approach to a credibility vs. risk dilemma, and bankers have to stick to the best business practices. Once again, then, we have to count on a proper approach to business and on a corresponding micro-responsibility in firms of the financial sector which will translate itself into an adequate macro-credibility, stability and high efficiency of the sector.

In this context, recommendations of many financial authorities addressed to credit institutions are of special interest. In July 2008 the Institute of International Finance published draft on principles of conduct and best practice recommendations. The Report, subtitled as Financial Services Industry Response to the Market Turmoil of 2007–2008, concludes that "the end of the financial market turbulence is not yet in sight, with a global economic slowdown and inflationary pressures stemming from oil and food prices weighing heavily on market sentiment. How soon this turbulence will end depends in large part on the continued attentive policies of major central banks, regulators, and, critically, on determined efforts by financial firms to strengthen their business practices (…)". The Report sets out recommendations understood as such industry standards, that can help to identify and accelerate the spread of best practices.

Addressed to the Institute's member firms The Final Report is of much greater significance. Prepared by the IIF's Committee on Market Best Practices sought both to state general principles for the industry as a whole and to provide benchmarks to many specifics that firms should use in refining their internal practices, thus seeking ways the industry could improve its overall performance and enhance the resilience of international markets. The authors of the report attach fundamental importance to risk management by observing that "Failures in risk management policies, procedures, and techniques were evident at a number of firms – in particular, the lack of a comprehensive approach to firm-wide risk management often meant that key risks were not identified or effectively managed.".

The principles of conduct, best practice recommendations, and considerations for the official sector were presented in six sections in the Report:

I. Risk Management,
II. Compensation Policies,
III. Liquidity Risk, Conduit, and Securitization Issues,
IV. Valuation Issues,
V. Credit Underwriting, Ratings, and Investors Due Diligence in Securitization Markets,
VI. Transparency and Disclosure Issues.

In its careful consideration of risk management issues the IFF Report points out that in the run-up to the U.S. subprime crisis, a buoyant environment of ample liquidity and strong economic growth provided the groundwork for a very competitive market for financial firms. In this environment, which was also marked by significant disintermediation, some firms overestimated the market capacity to absorb risk. Failures in risk management policies, procedures, and techniques were evident at a number of firms – in particular, the lack of a comprehensive approach to firm-wide risk management often meant that key risks were not identified or effectively managed. As a result, recommendations were summarized under the headings of governance and culture, risk appetite, role of the Chief Risk Officer, risk models and integration of risk-management areas, securitization and complex structured products, and stress testing.

As it has also been stressed in the Report, it is critical for governance to embed a firm-wide focus on risk. The market turbulence of 2007–2008 has provided clear evidence that effective cultivation of a consistent "risk culture" throughout firms is the main enabling tool in risk management. Each firm should:

- ❖ make sure that senior management, in particular the CEO, is responsible for risk management,
- ❖ establish the Board's essential oversight role in risk management,
- ❖ develop a robust risk culture that is embedded in the way the firm operates, covering all areas and activities, with accountability for risk management being a priority for the whole institution.

The firm's risk appetite should be articulated within a solid risk management framework, as a key part of an effective risk culture. Firms should:

- ❖ set basic goals for risk appetite and strategy and monitor how performance against such strategy evolves over time,
- ❖ consider all types of risk when defining risk appetite, including risks arising from the firm's relationship to off-balance-sheet vehicles,
- ❖ involve finance and treasury functions as well as risk in monitoring the overall risk of the firm.

Risk-management organizational structures need to be strengthened with an important role attributed to the Chief Risk Officer. As a result, firms should:

- ❖ assign responsibility for risk management to an officer at a senior level, in most cases a Chief Risk Officer (CRO) who should have sufficient seniority, voice, and independence from line business management to have a meaningful impact on decisions,
- ❖ ensure that the CRO has the ability to influence key decision-makers in the firm, with the mandate to:
  a) ascertain that the firm's risk level is consistent with its risk appetite, providing a thoughtful, integrated view of the overall riska the firm faces,

b) support senior management by identifying developing risks, concentrations, and other situations that need to be examined via stress testing and other techniques,
c) assess and control the firm-wide risk level; the CRO should compromise a number of advice, control, management, and technical oversight functions, including analysis of new-product development.

In a market environment that can produce unprecedented price moves and significant tail risks, seemingly robust risk-management tools and frameworks can prove inadequate. Hence, firms should:

- ensure that risk management does not rely on a single risk methodology, and analyze group-wide risks on an aggregate basis,
- ensure that metrics are calibrated appropriately to risk appetite horizons,
- take into account the technical limitations of risk metrics, models, and techniques (such as Value at Risk),
- eschew the "silo" approach toward risk management and take a comprehensive approach to risk, integrating strands such as credit, market, operational, liquidity, and reputational risk,
- ensure that the appropriate governance structure that has been adopted is actually implemented in managing day-to-day business.

During the recent stressed market conditions, a number of firms experienced losses in their activities related to securitization and complex structured products far in excess of what their models would have predicted. This underscores that firms should:

- take an integrated approach to risk management when dealing with complex structured products,
- ensure that risk models "look through" the direct risk and capture the market sensitivities of underlying exposures (e.g., mortgages),
- identify and manage risk concentrations–all sources of risk (including off-balance-sheet risks) should be effectively captured.

During the market turbulence, the magnitude of losses at many firms made it clear that their stress testing methodologies needed refinement–stress testing was not consistently applied, too rigidly defined, or inadequately developed. To help alleviate these problems, firms should:

- ensure that methodologies identify and take into account firm-wide risk concentrations, and integrate these methodologies into the overall risk-management infrastructure,
- ensure that stress testing includes pipeline and warehousing risks (e.g., with respect to securitizations and leveraged loans) where the firm accumulates positions for subsequent distribution, incorporating events that might delay or prevent such distribution,

- ❖ take account of the effect of stresses on exposures to leveraged counterparties–including potential cross-correlation of the creditworthiness of such counterparties with the risk of the assets being hedged,
- ❖ take an analytical and exploratory approach to stress testing. Its results should be taken into account in decision making, but such output should be used with an appropriate degree of judgment and not made automatic.

In their book on a history of financial crises, Charles P. Kindleberger and Robert Z. Aliber wrote: "The monetary history of the last four hundred years has been replete with financial crises. The pattern was that investor optimism increased as economies expanded, the rate of growth of credit increased and economic growth accelerated, and an increasing number of individuals began to invest for short-term capital gains rather than for the returns associated with the productivity of the assets they were acquiring. The increase in the supply of credit and more buoyant economic outlook often led to economic booms as investment spending increased in response to the more optimistic outlook and the greater availability of credit, and as household spending increased as personal wealth surged." (Ch. P. Kindleberger, R. Z. Aliber, Manias, Panics and Crashes, Palgrave/MacMillan, 5th edition, 2005).

History tends to repeat itself. Once again, in the mid of the second half of the first decade of the 21st century we participate in the financial tumult with – as the sign of the times – international repercussions. It started with an appetite for "subprime" lending and – via various vehicles – led to low market confidence. The trade-off between risk and public confidence comes into play (Fig. 1). New solutions are proposed for supervision and deposit insurance schemes (See: R. A. Eisenbeis, Agency Problems in Banking Supervision, in: Designing Financial Supervision Institutions. Independence, Accountability and Governance, ed. by D. Masciandaro, M. Quintyn, Edward Elgar, Cheltenham – Northhampton 2007; also L. Pawłowicz, Kto zapłaci za kryzys bankowy na europejskim rynku finansowym? Propozycje rozwiązań, Warszawa 2007).

Whatever the solutions of regulators and the resulting new or modified effective and efficient regulatory framework, adjusted as deemed necessary by the official sector within the safety net, to rebuild market confidence, maintaining high standards and best practices in the banking industry is a major issue. A contemporary credit institution must carefully evaluate its credibility / risk situation, and though aware of being a part only of the entire financial system it has to act adequately to accommodate its stakeholders' interests. Whatever the future solutions in the national or international institutional and regulatory framework, with higher and higher standards, and with rating agencies, supervision committees, and deposit guarantee funds, lower appetite for risk is highly recommended. Naturally, a contemporary banker doing business in an intrinsic international environment will "never be left alone" due to well developed regulatory and institutional framework but at the end it is him or her who will be responsible for the fiasco.

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