PRMIA Webinar

"Isn't It Time to Get Real on ERM?"

A Presentation by Financial InterGroup

September 2014

Financial InterGroup

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Introduction

On September 17, 2014, the Professional Risk Managers' International Association (PRMIA) hosted a webinar entitled *"Isn't It Time to Get Real on ERM?"* The presenters were Allan D. Grody and Peter J. Hughes of Financial InterGroup. A recording of the Webinar is available at www.financialintergroup.com.

At the end of the presentation, PRMIA's education director, Alex Voicu, moderated a Q&A session which is not available on the recording. Accordingly, we have prepared this transcript of the session.

The Lehman Brothers Collapse and the Legal Entity Identifier (LEI)

ALEX: Thank you very much gentlemen for being on the route of how do get real on ERM and maybe trying to answer the question "how much is green plus amber?" That used to be a question only poets could answer before so we're making a bit of progress here and it's good to know that we're going down this revolutionary path. You had some very interesting philosophical quotes and the one from Keynes really struck me particularly as institutional industry inertia is very hard to escape on many levels but it feels there are improvements on the way. You raised a few issues and I'm going to try to delve deeper in this Q&A session and feel free to underscore some of the points that you do want to make especially on the Risk Units method because I'd like to spend some time there on the methodology. I think there's more to dig but since we're so close to the Lehman anniversary why don't we start there. How different would it have been to unwind Lehman if we had the LEI system in place?

ALLAN: At its first moment we would have had knowledge of the risk exposures and who had them to Lehman. We did not have that knowledge.

ALEX: It's taken 18 months to find out.

ALLAN: It would have been of significant benefit. I'll give you an example. Three months after Lehman was declared bankrupt, there were checks going out from obligors, from counterparties, from people who were doing business with Lehman's subsidiaries, to those subsidiaries not knowing that they were part of Lehman, a bankrupt company.

ALEX: Sending free money away! Anything else you would like to say on that or should we move on.

ALLAN: Well I could say a whole ton because Lehman Brothers was the impetus for us going down to Washington and explaining to the regulators what went wrong at Lehman Brothers in their data issues around identifying their component parts of their organization. It was their revelation and I showed an earlier slide that Governor Dan Tarullo of the Federal Reserve Board basically said in 2010 parodying what we had been telling them since 2005 when we came down to Washington with a group of financial institutions to explain the problem of poor data quality and an inability to have a unique identifier for the financial institutions and their component parts. It was a problem we knew going back 30 years which we were trying to solve as an industry. We should thank the regulators that they grabbed onto it and are now pushing out a global standard but we need to help them because, as you can imagine, regulators and politicians aren't good systems developers and there are some major problems with the first beta implementation of the identification scheme specifically in the swaps data reporting and recordkeeping implementation that's going on in the USA and in Europe.

Risk Accounting's Treatment of Emerging and Other Risks

ALEX: Good work catching up with a so-called boring manufacturing industry that has the same... spot on. How would emerging risks be factored into the risk accounting model. Do you have a view on that?

PETER: I think I would respond to that. In terms of the templates that collectively comprise the risk accounting system the key ones have been expertly constructed, designed, developed, validated, weighted and so forth. A number of them have also been mapped to Basel sound principles papers so that the experts will have incorporated the mitigation effectiveness of an enterprise relative to all risks including the emerging risks you mentioned. So it is a kind of wholly dynamic and organic system and it really is a question of how the tables and templates are structured and maintained that would determine their responsiveness in terms of those emerging risks.

ALEX: Have you thought of a way of thinking about risks that aren't based necessarily on a consummated transaction, let's say, a business continuity breakdown.

PETER: We take the view that business continuity is part of the enterprise. We structure an enterprise to mitigate the risks inherent in transactions. So to have a well functioning business recovery plan is part of your risk mitigation system. In other words, if you have a weak or poorly functioning business recovery plan then, according to our terminology, you have an inherent risk, you have a low risk mitigation index and you have a high residual risk. If you want to improve that score then you implement a best practice business recovery plan. Your risk mitigation index will go up and your residual risk units will come down. The system is designed to calculate precisely those risk reduction benefits and risk mitigation improvements using Risk Units and the Risk Mitigation Index (RMI).

ALLAN: I would add one last thing. If you remember the two diagrams, one is the enterprise risk management system and the other is its centerpiece in the enterprise's overall ecosystem. In that diagram we have the board and management and its strategies and performance measurement systems interoperating with the enterprise risk management system. We're not eliminating the other well-developed disciplines that management uses: strategy, performance, even board meetings. We can't replace everything that human beings can do and have done well with an enterprise risk management system. What we're trying to do is incorporate all of the controllable components of the risk an organization takes on in one enterprise risk management system through one enterprise risk currency, the Risk Unit.

Probabilities vs. Risk Units

ALEX: Did you ever think about having a range of potential outcomes weighed by probabilities instead of exact amounts that come from accounting models. A side question. Have you heard of the confidence accounting concept. A few words on your thoughts on that.

ALLAN: To answer your question directly about confidence accounting, I did not hear that term used. To address your question more broadly about using probability measures, what we are proposing is not a replacement for the stochastic methods that are part of the capital calculations and the projections of VaR and all the stress testing uses for the probabilistic measures. What we are suggesting is we do not have an integrated risk management concept and we are suggesting that this is THE integrated risk management concept and we are building an enterprise risk management system to accommodate the methodology and its translation into the metric we call Risk Units. We've been piloting component parts of it for years now and getting good results and learning from it and, of course, we learn from the financial crisis and broaden its footprint to include all risks now. And it's the only risk management process that we know of that metricises all the fundamental risks... credit, liquidity, market AND operational risk into one system and one metric.

PETER: I'd also add to that, one thing that we are looking at is that there is an expected correlation between the residual risks which are the output of the risk accounting system and historic losses. So we would look over time to correlate those two in order to validate the risk accounting risk quantification method over time.

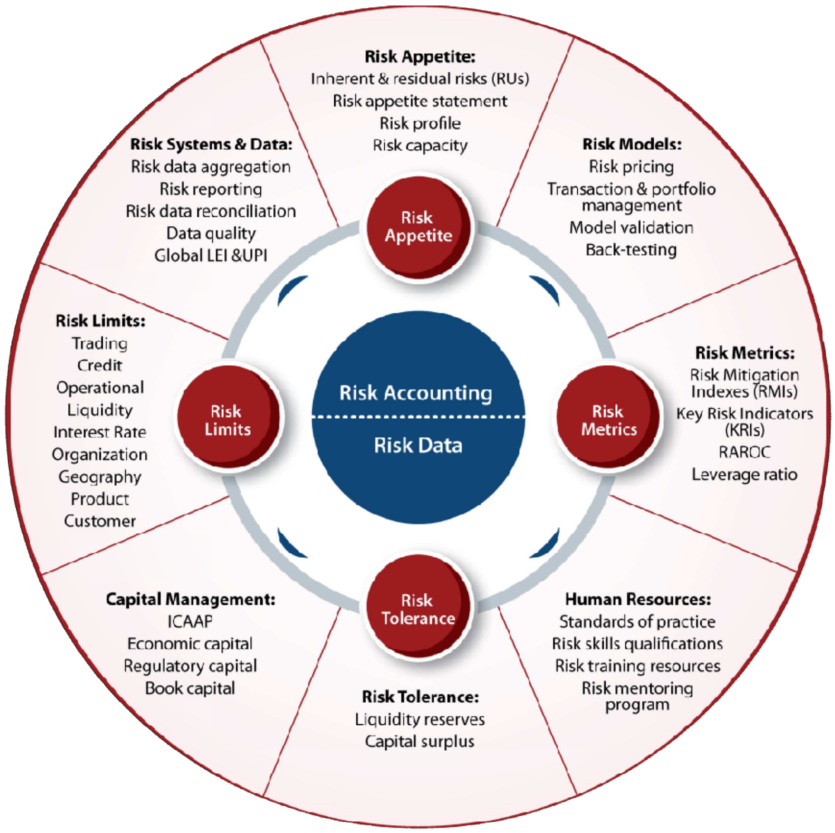
ERM Vulnerabilities

ALEX: Peter, can I ask you to go back to the diagram (on the next page) because I think it will be easier to focus the question and to translate the question with the diagram in front of us. You mention that if we don't get straight-through-processing we get the weakest link in the chain situation. Where do you think the system is most vulnerable as of today?

PETER: When you say 'the system', do you mean the enterprise risk management system as a whole?

ALEX: Right.

PETER: The greatest vulnerability has to be in the multiplicity of methods that we use today in order to identify or quantify an exposure to risk because that mere fact means that you have an impossible undertaking if you want to aggregate exposures to risk which really drove our thinking to say, well, if we want to solve this risk data aggregation issue we've got to have a universally accepted, standardized method of quantifying an exposure to risk. And as I mentioned when we looked at that particular slide it always registers with me with some shock that we have highly complex, technology-based interconnected global operating systems and the metric we typically use to manage the risks inherent in them is three colors. So surely we've got to start at least examining, exploring and testing ways of advancing that and we feel we've made a first step by saying, well, here is a method of quantifying an exposure to all risks, including operational risk, using a common measurement framework. That is the basic proposition.



The Integrated ERM Ecosystem

ALLAN: By the way, if you think about the vulnerability of the system, it's really the vulnerability of that slide that Keynes, Plato and Einstein were quoted as saying, the vulnerability is people's inability to step away from their comfort blanket and from their source of strength in knowing how risk management's best practices perform today, notwithstanding that it didn't work. Everyone is trying to make it better. The resistance to change is probably the most vulnerable part of what we're proposing today.

PETER: Alex, if I could just come back because I just want to make one point and that is when I said what I said I don't want the interpretation to be made that we're saying that there's something fundamentally wrong with key risk indicators – red / amber / green - because at the granular level that red indicator is absolutely critical to a well, properly functioning operation or piece of technology. What we're looking at is the enterprise level. How do we translate all those risk metrics, those oceans and oceans of risk metrics and data that we deal with – risk data – within a common measurement framework that we can aggregate? So I didn't want to leave the impression that we're saying key risk indicators are bad, they're absolutely vital. It's just at the enterprise level we've got to start thinking of something new.

Risk Units – Is There a Downside?

ALEX: Obviously... and thank you for making that distinction. I want to challenge your thinking a bit here as well because I think it's a great step forward. Any system has some downsides and maybe you've identified some of those with the Risk Units. Maybe it's the calibration of weights or maybe it's something else but where do you think are some of the downsides to the Risk Units?

PETER: The way you formulated the question, you make a very valid point that any risk management system must start life with a huge amount of subjectivity. When we think of credit scoring or the FICO score, those methods had their origins in subjective assessments and it's only over time through constant use, benchmarking, and correlation with actual loss data that you refine an accurate measurement system over time. Clearly, what we're discussing today, what we've just presented to you is a relatively new system so it will be some years before we can say with some conviction that the Risk Unit is representative of risk and is comparable but we've got to start a risk management system somewhere.

ALLAN: One of the things that our system project is expecting is to get a benchmarking organization, banks, others to input data into the system. We could have one particular department, for example, a credit department on-boarding a client activity across multiple financial institutions. If we get data from each organization and then create an index and benchmark each against the other without any one of them knowing what their numbers are we can refine the index and the Risk Units associated with those particular transactions passing through those particular departments. Having said that, you look at what we have now in the risk regime. Basically we are still in an experimental stage fine-tuning our metrics around value-at-risk, around capital. And you can see that from the 1988 Basel I to the future Basel IV where we're constantly incrementing the values, the VaR calculations are multiplied by three now because the VaR calculations didn't make any sense. We're getting additional capital requirements for the bigger organizations. They're incrementally making changes to what we think is, fundamentally, a flawed concept. But given that there's no other concept around, except for what we're proposing in terms of enterprise risk management, we need to start at the beginning and ask ourselves this question: "if this can work, and we believe it can, we've piloted it, then is it the holy grail of risk management?" Is it the thing that gives us the enterprise view of our risk-taking <u>AND</u> an ability to drill down to the causal factors so that we can mitigate risk? That's where those pillars of people-process, systems and data is so critical because those are the three drivers that control how we change our infrastructure to manage risk and manage other parts of our business.

Dealing with the Exponential Expansion of Bank Regulations

ALEX: Thank you. Very well said. One last question before we close. How much of the spirit of the law is being lost in the letter of the law and I'm focused here on the exponential expansion in the regulatory space that resulted in the last 20 / 25 years, especially in terms of being overly prescriptive on certain laws and how efficient was that process.

PETER: Can I kick that one off? A couple of thoughts come to mind. First of all, I've been in relatively senior roles in banking for about 30 years. I find it eternally depressing that I now look at bank regulation and the rest of it that, to be quite frank, I don't understand. It cannot be good for our industry that so much that is labeled 'regulation' is probably incomprehensible to boards of directors for example. So we have created a significant issue for ourselves. But it's a problem that we created. It's not a problem the regulators created. If we demonstrate an inability to effectively manage the risks inherent in our enterprises then the regulators will respond with the only tool that they have and that is regulation or legislation and that's the monster we've created. We're kind of hopeful that what we've demonstrated today is perhaps a response to what the regulators themselves are asking for as Allan illustrated; more simplification, more comparability etc. within the regulatory framework.

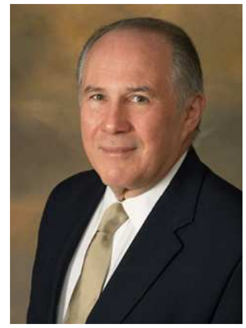
ALLAN: The only thing I would add is talking to boards and seeing the board package that they get on risk management they need something simpler.

ALEX: The 'Board-Books' they're getting you mean.

ALLAN: Yes, the 'Board-Books'. It can't be understood unless somebody comes in and interprets them and makes a presentation to them. That's number one. And an anecdote... one of the board members once asked me, "Allan, all of the indicators are red. What do I do?" That's number one. Two... regulators, when you close the door, they've got sweat on their brow also because they have no ability to implement this, only to make judgments on how we're doing in implementing it. So the industry needs to come together, and especially the SIFIs, there's 30 banks and there are 9 or 13 other big, global systemically important institutions and basically say to the regulators, yes, we hear you, we want to "take the bait" as I said and take these regulations and implement them in ways in which we think will work for us and for you and I'm sure they'll all breathe a sigh of relief except for a few who think they know more about our business than we do. I can tell you for certain, as much as we think we know about our business, we don't. It's very complicated, as you all know. So I think the regulators would look for a partner in the financial institutions and the partnership should start with the big SIFIs, they're the ones that are identified as the most significant to the regulators and, therefore, their CEOs have to relate to this stuff. Perhaps people listening to this can present it to them or ask us to present it to them or send it to them and tell them we want to do something different because what we're doing now is weighing down our technology infrastructure, weighing down our compliance and governance infrastructure and costing us more money and, in the end, if our system collapses again, the regulators are going to blame us for not implementing something that was unimplementable.

ALEX: Thank you Allan and thank you Peter and I think intellectual humility is a good note on which to end and I wish you the best of luck in getting more-and-more acceptance for the Risk Units. I thank all our members for attending and we'll be back on the beginning of October with the Fundamental Review of the Trading Book progress update. Have a great week everyone.

Financial InterGroup Principals



Allan D. Grody

Allan is the founder of the Financial InterGroup companies. He has been active in the financial industry for over four decades and has had hands-on experience in multiple sectors of the financial industry. He advises on domestic (USA) and international issues related to financial institutions' global strategies, restructuring and acquisition needs, information systems, communications infrastructures and risk management systems.

In an earlier career, he was the founder and Partner-in-Charge of Coopers & Lybrand's Financial Services Consulting Practice, which was subsequently merged with Price Waterhouse and eventually sold to IBM. Professor Grody founded and taught the only graduate level Risk Management Systems course at NYU's Stern Graduate School of Business. He also lectures on financial markets, financial information systems and venture investing.

Peter J. Hughes

Peter is a Principal of Financial InterGroup and Managing Director of its UK based company. He is a former country/regional executive with JPMorgan Chase, Fellow of the Institute of Chartered Accountants in England & Wales and a Visiting Fellow at the Leeds University Business School (UK).

At Financial InterGroup he leads consulting projects and provides advisory and training services to some of the globe's leading banks, global IT and consulting firms, trade associations and banking institutes with particular emphasis on cross-enterprise risks, operational risk, Basel II & III, capital management (including the Internal Capital Adequacy Assessment Process - ICAAP), finance transformation, accounting (including IFRS), data management, risk measurement and management systems and risk based auditing.

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