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Systemic risk: a second chance for ERM

Summary
Traditionally, bank regulators have been concerned with the stability of the financial system as a whole rather than the soundness of individual institutions. It has, however, taken the last crisis to make systemic risk the explicit focus of regulation. Banks, for their part, have toyed with 'Enterprise Risk Management' with mixed results. There are lessons to be learned from that experiment for systemic risk. Likewise, the latest thinking on systemic risk can help revive ERM.

Dear reader,
Two publications[1,2] were issued recently that shed some light on the regulator's thinking about systemic risk. In the US, the proposed senate bill suggests a seismic shift towards creating an integrated regulator, increasing consumer protection, combating moral hazard by downsizing those too-big-to-fail companies as well as regulating derivatives trading, hedge funds and rating agencies.

Meanwhile, the BIS / IMF / FSB paper takes a more analytical stance and discusses the appropriate way to asses systemic risk. It focuses on three aspects: size, substitutability and interconnectivity. The middle term seems particularly ugly. It refers to a kind of key-component-exposure, analogous to key-man-exposure. In this concept, parts of the financial system that perform a unique role have the lowest degree substitutability, thus contributing far more to the systemic risk than those components whose function can also be performed by another component.

Definitions
The same paper defines systemic risk as: "a risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy." It continues to state: "Fundamental to the definition is the notion of negative externalities from a disruption or failure in a financial institution, market or instrument."

The proposed bill does not define systemic risk, but implies that it refers to risks "posed by large, complex companies, products, and activities." This is at variance with the BIS / IMF / FSB approach which states hat "all types of financial intermediaries, markets and infrastructure can potentially be systemically important to some degree."

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1 From the US Senate Committee on Banking, Housing, and Urban Affairs: "A Bill to identify and address risks to the stability of the United States financial system…."
Full Text (1136 pages): http://banking.senate.gov/public/_files/AYO09D44_xml.pdf
Summary (11 pages): http://banking.senate.gov/public/_files/FinancialReformDiscussionDraft111009.pdf

2 From the Staff of the International Monetary Fund and the Bank for International Settlements, and the Secretariat of the Financial Stability Board: "Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments, Report to G20 Finance Ministers and Governors, October 2009:
Initial Considerations (29 pages): http://www.bis.org/publ/othp07.pdf?noframes=1
Background Paper (46 pages): http://www.bis.org/publ/othp07.htm

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Strategic risk is to Regulators what Enterprise risk is to Financial Institutions
Both papers urge for comprehensive data gathering, detailed analysis and timely disclosure. The BIS / IMF / FSB makes a interesting point in this regard. It acknowledges the wide ranging nature of systemic risk, and in addition to a call for a host of indicators, it states that "the framework cannot be seen as a precise quantitative instrument, and assessments of systemic importance are likely to be judgment-based and not binary in nature." What is asked here is to take all manner of internal and external environmental data, including business processes, systems, markets and product complexity into account to come to a measure for systemic risk.

At the corporate level, this is close to what ERM should do. So far, however, ERM has failed to develop a viable methodology of its own and is usually no more than someone holding a stapler. The emergence of a methodology for the analysis and management of strategic risk therefore provides a welcome second chance for a more mature ERM approach.

What can ERM[3] do next?
ERM should make a fresh start by closely studying the proposed approach for the analysis of strategic risk. Three avenues should be explored:

- First of all, ERM should develop a specific risk rating. For systemic risk, the suggestion is to create an assessment framework with a letter graded scale (say A to E) along the stipulated dimensions size, substitutability and interconnectedness. These aspects are in turn made up of various indicators and assessments. This simple approach is something that most banks have failed to create for ERM. This lack of a specific ERM rating is the clearest sign that ERM does not come of age.
- Secondly, a wide range of indicators should be gathered. Enterprise risk just like systemic risk will not be defined by fixed and limited set of indicators. The indicators themselves and their weights will vary over time, by geography as well as according to external circumstances and shocks. The challenge will be to harness these indicators and to neither over-determine nor over-simplify the models.
- Thirdly, the use of ERM in policy decisions must be made explicit. Just as strategic risk needs to be transparent to enable better consumer protection, so ERM measures need to be made transparent to ensure banks live by their assessments.

Conclusion
The global response to the 2008 crisis has paved the way for a serious treatment of strategic risk. That approach is likely to shift and develop further over the next few years. This is good news for anyone who is interested in comprehensive risk analysis. Much the same approach can be adopted in financial institutions to breath life into a moribund ERM programme. Perhaps we will even see an ERM-rating as input for strategic risk models.

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[3] From here onwards, the remarks on ERM also apply to ORM, which suffers from the same shortcomings and which would benefit from the same steps.