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Summary: A rethink of the common bank business model is needed, but what should it focus on. This newsletter points out some directions for risk management and argues for a greater role of risk management in banking for 2009 and beyond.

Dear reader,

We have been told repeatedly that the new way for banking is to return to a simpler form of basic banking. The Glass-Steagall Act of 1933 comes to mind and is now once again paraded in various guises as a way to avoid crises like the current one in future times. It may not be as simple as that. Out-of-control leverage, multiple asset bubbles, regulatory arbitrage and synthetic products that purported to spread risks but in fact only hid them from view all played a role, but a deeper problem also need to be tackled. That problem is intimately linked with the unavoidable risk in running a bank on the one hand and with the way risk and uncertainty are perceived and managed on the other hand.

Unavoidable risks in a bare bones banking model

Take, as a starting point a world that consists only of two privately owned banks that both operate a simple model. Both banks take deposits on which they pay a certain interest rate, and both lend at a higher interest rate. Those are the only two products the banks have on offer. It does not get any simpler than that. They also share the same profit targets and they are the same size[1]. Let's assume for a start that both banks are borrowing at 3% and lending at 6% annually[2].

We do not need to look far to realise that depositors at bank A and bank B are not necessarily exposed to same risks, nor indeed are the owners of the bank. Apart from the externalities (such as jurisdiction, currency, regulatory treatment, depositor guarantee schemes which we will all assume to be identical for both) a host of distinguishing elements remain.

The quality of the borrowers will be a crucial factor in the bank's capacity to profit and to satisfy the depositors and owners. The quality of internal rating models will play a part, as well as the accuracy of the data, the soundness of the stress tests, the ability to interpret results correctly and the foresight to adjust the model when external developments warrant a modification of earlier assumptions. The capacity to collect debts as well as the ability to ascertain and monitor collateral, and indeed the overall administrative capabilities and quality of systems are other factors with the same effect of leading to different risk profiles. The understanding of, and compliance with, the rules and regulations are factors that also help determine the ultimate level of risk.

Making a difference

Now assume that bank A lends at 6% as before, while bank B charges 12%. Something is going on here. Since we note that the risks outlined above are inherently different per institution, this difference could be entirely natural. Maybe bank B is operating among clients with lower credit

[1] Measured by staffing levels or number of branches or similar metrics.

[2] As the rather lame joke used to have it: "The golden 3 – 6 - 3 rule for bankers". Borrow at 3%, lend at 6% and be on the golf course by 3 o'clock.

ratings and expects to suffer higher default rates and therefore needs to set higher margins. Maybe bank A is more astute at monitoring collateral, or only accepts a limited range of less volatile collateral and can thus afford to charge less.

If this was all, bank B would simply not attract the same quality borrowers and wither away. But another effect will be that bank B needs to pay its depositors more to attract savings, say 6%. Now, the bad money driving out the good money starts. Savvy depositors may have demanded the higher rate to knowingly take on the risk of the poor borrowers that bank B has, coupled with the shoddy systems and lackadaisical procedures. But information asymmetry abounds among depositors. Soon, flocks of depositors will start to shift from bank A to bank B attracted by the higher margins.

It will soon run out of borrowers willing to pay 12%, and at the same time, it will start to attract deposits from lazy account managers in bank A. This is basically what the ‘feeder funds’ in the Madoff scheme were doing. Now, both individual depositors and wholesale account managers of bank A are all flocking to bank B for yield. This will stretch the bank’s capacity beyond acceptable limits when it needs to attract more borrowers too and will need to accept ever dodgier clients. Ultimately it will have to borrow to the most risky clients and it will not be able to sustain its business and collapse under its weight in bad loans.

What is comes down to (if you care to re-read paragraph 4) is that actual risk is dependent on the quality of the internal processes, the ability of staff, integrity, the appropriateness of models used and the capacity of the systems and overall administration in place. But here is the curious thing, Although these factors determine the real risk, depositors are being lured into believing all banks are equal. Part of this is due to the need to maintain faith in the banking system. One might expect the market to correct for this, but the market is notoriously bad at predicting anything.

So what is the remedy? The first step has to be that regulatory oversight must be rigorous, and for that, standards must be clear to all, enforceable with ease and relevant to the problem. At the moment, banking regulation fails on all of these counts. The move towards principle based regulation sacrificed clarity for brevity. The home host discussions on enforceability are a moot point by now, but it has clearly not increased. Relevance is a particularly worrying point, and there is a risk of creating new rules for situations that no longer exist.

What next?

With the sound of investment bank operations shutting down all over, and a return to the simple ways of banking, the problems of risk management do not go away. Prudential banking may be back, but risk management still needs to learn the lessons from 2008 and before. To get into shape, it must get involved with the re-creation of the banking business model. Merely limiting the range of products will not do the trick. The problem is actually under the hood, and is embedded in the banking practice of not fully accounting for the quality of people, processes and systems within its operation. It is the duty of Risk Management to address that gap.