GLOBAL riskupdate

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Managing Risk in a Volatile Landscape

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CREDIT-RISK MANAGEMENT
MAKING THE "RIGHT" DECISION

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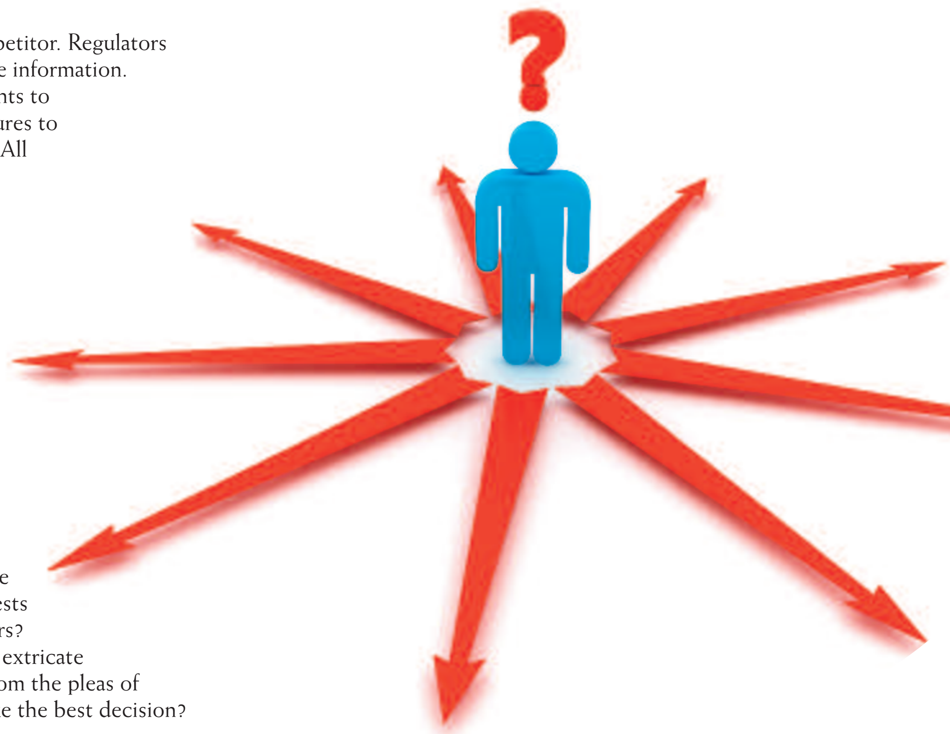
The senior risk manager at a major bank faces a routine day. The head technology banker wants a decision to lead a billion-dollar syndicate-finance deal for a telecommunications company. The capital markets head wants to do a billion-dollar swap deal for a hedge fund with a volatile track record. Another banker wants to do a variation of a "covenant-lite" deal, where the borrower doesn't represent it is performing up to financial standards.

Another wants permission to wire out a billion dollars on behalf of a client with no cash in its accounts. Another asks for guidance on how to handle a client that just announced bankruptcy. And it's not yet 10 a.m.

For the senior risk manager, it's just another day—an anxious sequence of decisions that will have impact on business groups, growth, clients, bankers, compensation and the long-term risk profile of the institution.

How do risk managers make decisions? How should they? How can they learn from mistakes of the past or decisions others made that triggered the recent financial crisis or set it in motion?

Experienced risk managers are accustomed to making decisions, setting guidelines, and establishing policy. Some enjoy the privilege of having impact. Some shy from the responsibility and defer to others or to a committee. Most are used to the crushing demands of business leaders, regulators, clients, and bank boards. A trading desk demands to do a complex, mind-boggling trade. The investment-banker wants to do a deal before it's lost to a competitor. Regulators press for more information. The CEO wants to review exposures to large clients. All in a day.



How does the risk manager ensure the right decision is made—free of subjective viewpoints, free of biases and without catering to the specific interests of stakeholders? How do they extricate themselves from the pleas of others to make the best decision?

Risk decisions usually emanate from a hierarchy of risk managers. Those with experience or have proven records in past scenarios or transactions are granted more authority. The hierarchy determines who makes the decision and how. Risk managers will get in-depth input before decisions are made. They review pages of analyses, hear business arguments, and host meetings to discuss pros, cons and points of view. They confer with peers and business leaders. When it is time, they make a final decision—yes, we proceed; no, these aren't the kinds of exposures we want; or maybe, if you get more details and answer more questions.
In today's fiercely competitive environment, risk managers are asked to make decisions with little time to ponder or without time to understand the long-term impact or realize the precedent the decision might be making. Everybody pushes for an answer now, because if the deal, trade or transaction is not made, the client or counterparty will flee to another bank – along with potential revenues.

So the best, shrewdest risk managers learn how to make decisions with their backs to the wall and in the face of what appear to be threats or undue pressures. They understand the habits or styles bankers and traders, who keep pressing until they hear "yes" or seek out other risk managers with similar authority to appeal a "no" decision.

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The best, however, avoid threatening situations and set parameters in advance. They set guidelines for clients, exposures, risks, deals and trades and describe explain the transactions they say they will likely approve. They have discussions with bank units about risk profiles, trends, prudent risk-taking, clients and risks-vs.-rewards.

Thus, bankers and traders operate knowing what will be approved and what won't. Still, backs-against-the-wall situations or midnight calls inevitably arise. With guidelines and benchmarks, there will at least be blueprints around which critical decisions are made.

Impact of Decisions

To make the right decisions, risk managers should know the stakeholders – whom major decisions might affect. A decision on a transaction made in one day can have impact on businesses and portfolios for years. Who is affected by a risk decision? It can be:

1. Business units, who rely on risk managers to approve deals, transactions, and trades that influence growth, performance and the business unit's niche among competitors and others in the industry.

2. Employees, who will be affected by decisions that affect business output, productivity, internal visibility, and incentive compensation.

3. Senior management, whose management of businesses will be influenced by decisions across portfolios, exposures and bank products.

4. Clients/counterparties, who rely on decisions for deals or trades that have pivotal impact on client businesses, expansion, growth or hedging strategies.

5. Other risk managers, who assist in managing portfolios across the bank, who decide whether overall risks must be hedged, who oversee policy and who seek to avoid risk concentration.

6. Boards of directors, who oversee bank performance, must ensure prudent management of risks, clients and portfolios and ensure risks are measured and diversified.

7. Regulators, who enforce legal guidelines, but observe trends in the bank's risk profile and evaluate specific risks, clients, and products.

Decisions tied to large exposures will have a visible impact and might initiate a response from stakeholders. The decision could raise a flag with regulators, could impede a client's planned acquisition or could affect a banker's bonus. A decision, too, could be the difference between a bank surviving a crisis or being overcome by it.

Decisions tied to small exposures aren't visible, yet the cumulative effect of dozens or hundreds of small exposures will have a substantial impact on some stakeholders.

Risk managers, therefore, should be aware of how the decision affects any among this group and should measure both the short- and long-term impact.

Influences in Decision-Making

Experienced risk managers know their clients, portfolios, counterparties, and businesses. They often know markets and industries. They have endured or witnessed crises, client bankruptcies, market downturns, or business disruptions. They tap into experience and knowledge to make risk decisions.

Knowledge, judgment, and experience will steer a decision. But risk managers will be influenced by an array of factors. Styles, character, traits, and biases come into play. That's inevitable, since they are human. To make good decisions, they must learn to harness certain habits, biases, or traits and approach the decision in objective ways.

They will exhibit many personality traits, as they work with bankers, traders and colleagues. They are congenial, collaborative, or aloof. They can be autocratic, overconfident, dismissive, argumentative, supportive, contemplative, or pleasing. They can be ponderous, inflexible, introverted or hierarchal. They are one way with business units, another way with senior managers and yet another with others. These styles might affect decision-making.

Risk managers will show a general propensity for risk in transaction decisions, portfolio management or client management. Some are:

1. Risk-averse, confident that the worst will occur and not sure risks can be reduced or hedged. A few are risk-averse, not because of a fear of risk, but because of a personal desire to exert authority or to ensure job security.

2. Risk-taking, confident risks will not exceed certain levels and can be managed, hedged, reassigned or

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sold off. A few might be risk-taking, not because risks are prudent, but because of a trait to show confidence and fearlessness.

3. Risk-neutral, confident risks occur within a manageable range and are influenced by market conditions, situations or trends. Some waver. Sometimes they are risk-averse; other times, risk-tolerant.

A propensity for risk is influenced by personality traits. But it is also be influenced by other personal factors:

1. Financial objectives
2. Professional objectives
3. Incentive compensation
4. Employment stability
5. Use of appointed authority

If compensation is based on minimizing risk losses, the most risk-taking risk manager may become more risk-averse. If authority is important to the risk manager, then a risk-neutral risk manager could become more risk-taking or risk-averse to demonstrate it.

Experienced risk managers, therefore, should understand personal objectives, styles, and propensities and manage these tendencies to focus on the best decision. The combative, power-hungry risk manager, for example, who holds a grudge against a business leader must learn to suppress these tendencies when it's time to make the right decision.

Business factors influence decisions. Bank units aggressively take steps to win business, increase revenues and improve results. Businesses will have short- and long-term goals, profitability benchmarks and ROE hurdles. Bank units will seek to improve reputations in the industry or climb higher up league tables. Risk managers know business units must generate profits; they know businesses seek greater market presence. But it's not always easy for them to isolate themselves from these pursuits to make proper decisions.

Client-related biases influence decisions. Many important clients have long-time relationships with banks. Bankers may have special, entrenched relationships with some and may explain risks in irrational ways to approve transactions with familiar (or favourite) clients.

Risk managers may, too, encounter client-related "threats" when they review transaction terms: A top-tier client threatens to flee to a competitor if a deal under review is rejected. Risk decision-makers are familiar with this scenario, but must learn to make decisions without regard to occasional threats.

Past experiences become influences. Risk managers who sloughed through the recent financial crisis or past crises (Asia, Latin America, Long-Term Capital, stock-market crashes, technology bubbles, sovereign debt, real estate, Enron, and Worldcom) try to avoid the next one. The memory of an event or a lingering stench of work-outs, restructurings, and bankruptcies will influence the next decision.

Past experiences shouldn't be minimized. They offer lessons and help frame future decisions. They could paralyze decision-making if risk managers fear a repeat episode. Past experiences might lead to avoidance of risks: Avoid risks to avoid work-outs and bankruptcies. Avoid risks to avert negative publicity or public criticism. Or avoid risk to minimize the probability of write-offs, business shrinkage, or reputation damage.

But others might treat past experiences as one-time occurrences and dismiss the likelihood of another crisis soon.

Regulatory oversight influences decisions. Risk managers, before a decision, will gauge how regulators will assess or second-guess the decision later. With pending regulatory reform, they might assess how regulators will opine in periods to come and could make decisions in anticipation of regulatory changes.

Banks' risk cultures influence decisions. Culture includes governance, organization, corporate structure, and the tone CEOs trickle to those below. The organization will have expectations for the role of risk management. Management structure might limit the voice of risk decisions or permit it to have substantial weight. A structure that limits the enforcement of a risk decision might result in unclear, casual decisions.

Experienced risk managers juggle these influences daily. They understand personal traits, objectives and biases. So how do they control these factors, isolate them when necessary, or tap them when it's appropriate to make the right decision.

The "Right" Decision

There is no fool-proof process to approve risks that will result in no losses. There will, however, be attempts to make the "right" decision to minimize losses, manage portfolio exposures, and stay within the lines set by risk policies.

But what is a "right" decision? The right decision is more an unbiased, fair process, not always the end result. It may entail:

1. Prudent, careful judgment of deals, transactions, and clients

2. Fair, objective approaches to reach a decision

3. Understanding and control of personal biases, traits and business influences

4. Assessment of risks vs. rewards (business gains)

5. Unbiased perception of worst-case scenarios or what can go wrong

6. Strict adherence to risk policies, guidelines, and portfolio objectives

7. Thorough understanding of business-unit goals

8. Adequate input from informed, knowledgeable people

9. Sufficient and detailed analysis and research from experts

10. Understanding of compliance, legal, and regulatory parameters
11. Approvals with low probability of loss

12. An awareness of contingencies and options to reduce or hedge risk of loss

The "right" decision may be "yes," "no," or a plan, guidance and instructions on how to manage a risk scenario.

"Bad" Decisions

Bad decisions, or wrong decisions, are made periodically. They led to approval of mortgage-related risks, the on-boarding of clients with bad reputations or bad business models, disastrous derivatives trades, or the approval of a large syndicated loan to an industrial

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that fell into bankruptcy a year later. They may be characterized by:

1. Inexperience or inadequate knowledge among decision-makers
2. Miscalculation of risks and probability of losses
3. Insufficient analysis, details or information
4. Fatigue, excess workload, and insufficient staff
5. Excess, cozy influence from business units and their goals
6. Lack of understanding of complex, primary risks
7. Inadequate review of worst cases
8. Excess optimism regarding projections and market trends
9. Inability to manage "policy slippage": loopholes and exceptions

Making the "Right Decision"

After they understand biases and influences and appreciate history, experience and knowledge, how can risk managers ensure they make that "right" decision?

1. Set the tone beforehand. Provide guidance and parameters for how decisions will be made and what risks, exposures and clients will be tolerable.
2. Know who the stakeholders are. Who will be affected?
3. Understand and limit personal biases and influences.
4. Deliver the message clearly, succinctly and with authority. Be confident, independent, rational, logical and persuasive. But be prompt and responsive.
5. Make sure the decision is consistent with policies, guidelines and limits. If the decision is an exception to policy, explain why.
6. Employ lessons of past crises, events and experiences.
7. Use tools, metrics, benchmarks and statistics, but allow them to advise, but not make the decision.
8. Use unbiased approaches to get closer to the decision. An approach can be based on:
   a. Assessment of risk-returns
   b. Impact on total client/counterparty risks
   c. Impact on portfolio risks
   d. Review of scenarios, conflicts and outcomes
   e. Review of impact on stakeholders
   f. Review of long-term impact of the decision
9. Allow free-flowing input from experts, analysts, and those knowledgeable about products, deals, clients, and industries.
10. Use mature judgment. Be accountable.

All the familiar risk scenarios (deals, trades, transactions, clients and counterparties) will continue. There will always be an urgent demand for decisions to facilitate getting deals done, trades booked, funds wired, or clients on-boarded. If biases can be controlled, influences understood, and the impact on stakeholders properly measured, then the "right" decision can be made more often than not.

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