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by

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Introduction

Chairman Reed and other members of the Subcommittee, I thank you for the opportunity to address the critical topic of risk management and its implications for systemic risk.

I come to you today with a rather unique perspective on this topic. I have worked in the financial services industry for 35 years, the first 17 of them as a regulator with the Office of the Comptroller of the Currency (OCC). Nearly all of my time with the OCC was spent working with problem banks.

In my capacity as head of Special Supervision from 1986 to 1990, I was responsible for overseeing the most deeply troubled and failing banks in the national banking system. The unprecedented number of bank failures during that time gave me a rare insight into risk and risk management.

After the OCC, I spent the next 17 years in the banking industry, first as a turnaround specialist for Ameritrust Corporation, a deeply troubled regional bank domiciled in the Midwest, and thereafter in a variety of risk management positions, including more than a decade as Chief Risk Officer of KeyCorp, a $100 billion financial institution located in Cleveland, Ohio.

In July 2007, I was named President and CEO of The Risk Management Association, a not-for-profit organization dedicated to promoting sound risk management principles in the financial services industry.

RMA has been fulfilling its role for nearly 100 years. It has approximately 3,000 corporate members, ranging from small community banks to the largest financial institutions in the world. It also has approximately 20,000 individual members who work in the risk management profession.

RMA today is an organization in close contact with its members on the issues they face and what they are trying to do about them. We routinely communicate with the risk professionals who are among our members, including senior risk officers from the largest global commercial and investment banks.

I should also mention that even though RMA is an industry association, it does not engage in the business of lobbying. We believe our efforts are better spent serving our members as a conduit of information on effective risk management practices.

State of the Financial Services Industry

The issues facing the financial services industry are widespread, complex, and scary. The capital markets have seized, billions of dollars have been written off, and the financial services industry is rapidly de-leveraging, resulting in a paucity of credit for needy borrowers. The initial liquidity-driven problems of 2007 are now giving way to deteriorating asset quality in 2008, posing another potential round of losses for the industry.

Things are not good, and it's hard to be optimistic about the foreseeable future.

The financial services industry is a vital component of the national and world economies, and it is deeply wounded right now. It needs time to sort out what happened, why it happened, and what needs to be done to prevent it from happening again. To ensure it doesn't happen again, many industry participants will have to change the ways in which they did business.

We have to be careful of the solutions we put into place, however. Simple fixes born from knee-jerk reactions are not appropriate for complex problems. The problems are multifaceted and the solutions must reflect that fact. This crisis was a collective effort of failure. There are many culprits to point the finger at, and singling anyone out would be inappropriate. Trying to fix one issue without considering its domino effects can actually worsen the situation.

Whether solutions come from bank management, regulators, or legislators, we must be careful not to compound an already very tenuous situation.

Difficulties notwithstanding, the current environment affords an excellent opportunity to learn from mistakes and improve risk management processes going forward. As we muddle through the misery, we are all smarting from it and smarter for it. There is recognition within the industry that mistakes have been made. Major mistakes. And there is also a genuine determination that, as an industry, we need to do better.

State of Current Models and Systems for Measuring Risk Management at Large Financial Institutions

I will state up front that I am a firm proponent of models. I have personally seen their utility in many ways, be it for pricing products, predicting behavioral characteristics, or stratifying risk. Models are like nuclear energy, however. Handled appropriately, they can be very useful and very safe. Handled inappropriately, they can be a disaster.

The reputation of models has taken a tremendous hit as a result of the current market crisis. I think this is unfair. Blaming models for the financial market crisis is like blaming the car for not running after you've filled the gas tank with water.
Models are inanimate tools. They don't create themselves and they don't think for themselves. They are built *by* human beings *for* human beings. It is the humans who develop the formulas that drive them. It is the humans who develop the assumptions fed into them. And it is the humans who interpret the output from them.

The recent debacle has pointed out many ways in which models can be used inappropriately. Models, by nature, have a historical base. They use the past to try and predict the future. What are we to expect when we take historical data from one type of loan and then force-fit it into a model to predict the outcome of a completely different type of loan? I cite, for example, the modeling that supported the subprime mortgage business in the mid-2000s.

Subprime mortgage lending has been around for a long time, but never before has it produced the results we have seen play out in 2007 and 2008. Some of the models used to forecast performance were based on data from loans whose underwriting standards were diametrically opposed to those of the mid-2000s. The historical data was based on credits with conservative loan-to-value and debt-to-income ratios. Borrowers were fully vetted as to their employment and payment histories. This same historical data was used to forecast the performance of borrowers with little or no down payments, high debt-to-income ratios, low- or no-supporting documentation, and a “qualified” status achieved through teaser rates.

We shouldn’t be surprised that the performance of recent vintage subprime loans was dramatically different from that of their older brethren. That’s not the fault of the models. That’s the fault of the humans who fed them erroneous data.

There has also been much criticism that value-at-risk (VaR) models failed during the recent turmoil. VaR models have inherent weaknesses that must be recognized and worked around. For example, VaR models use backward-looking information to forecast the future. If the data captured in the model comes from a benign environment, it will temper forecasts for future periods, even as markets become more volatile. Stale volatility assumptions can quickly render the VaR forecasts obsolete. Further, VaR models depend on confidence intervals: A 95% interval implies the models will be wrong one out of every 20 days. These shortcomings, and others, should not render VaR models useless. Instead, they imply that management needs to pay closer attention to current market volatility and adjust assumptions accordingly. In addition, the models should be supplemented by other risk management tools, such as scenario and stress testing, to ensure a more holistic approach.

There are, of course, times when modeling can be carried too far, such as when it becomes modeling for the sake of modeling. For example, when I was a Chief Risk Officer, I was presented with the opportunity to enhance earnings through the use of a U.S. Dollar-Denominated Inverse-Floating French Franc–Deutsche Mark Indexed Amortizing Swap. This struck me as an earnings tool so difficult to understand that it was functionally useless, built by a group of "quants" trying to see how creative they could be—much like those who built today's collateralized debt obligations.

As risk management tools, models are in their relative infancy and will continue to mature as more time passes. Despite their many shortcomings, we cannot—and should not—abandon them. Instead, we should seek ways to work around their weaknesses. We should use them not as a substitute for human judgment, but rather for making a more informed human.

Adequacy of Risk Management by Risk Officers and Executive Boards, Including the Sharing of Information and Communication Among Senior Management

Financial risk management is an art that has been around since the dawn of commerce. Until very recently, however, it was an intuitive process, honed and refined by millennia of bad decisions. It is still very much intuitive, but it is now being supplemented by sophisticated tools and processes designed to keep up with rapidly expanding companies, products, and markets.

In 1990, the largest financial institution in the United States was barely $100 billion in asset size. A mere 20 years later we have companies that boast trillions of dollars in assets. These companies span the globe in their operations and offer a broad array of products and services that meet even the most arcane financial needs.

This phenomenal expansion of size and products has occurred during a time of enormous economic growth for the United States. In such a robust economic environment, it is often difficult for many to focus on risk and risk management. Risk is dormant and, as such, it gets the "out of sight, out of mind" treatment. Consequently, we should not be surprised that risk management processes have not grown commensurately with the industry's dollar assets, products, and services.

The industry has not totally ignored risk management, however. We have seen many impressive advances across the spectrum, ranging from statistical analysis of risk through the use of technology to the creation of formal risk organizations within companies. We've seen the implementation of new-product-review processes that force us to understand what we are doing before we actually do it. We've also seen the implementation of comprehensive self-testing processes to monitor the effectiveness of accounting, internal, and compliance controls. Many companies have also designated a Chief Risk Officer to ensure that at least someone is always focused on the business of risk management.

Despite these advances, we still have a way to go. As an industry, we will never achieve perfection, and we need to acknowledge that. Banking is a business of risk: We must take risks to generate profits. In doing so, we will make mistakes. We always have and we always will. Our objective is to minimize the damage from mistakes when they inevitably occur.

The new processes we have developed over the last two decades will help. But these new tools are no substitute for other fundamental principles of risk management. There are certain risk management rules by which our industry must abide. When we don't, we get into trouble. The recent market debacle is a prime example.

A fundamental principle of risk management is that it is not one person's responsibility. It is a collective effort. Everyone in the entire organization must be a risk officer, from the board of directors down to the lowest-ranked person in the company. They must know the risks they take, mitigate them as best they can, and appropriately price for those that must be taken.

The recent turmoil offers numerous examples of where this fundamental principle was not followed. In many cases, boards of directors did not know the risks the company was taking. And it was often questionable if the directors had the expertise to understand the risk even if they had tried. Moreover, these boards failed to put in place an incentive scheme that would have induced bank management to focus on risk.

There were CEOs who were more attentive to short-term revenue than to the risks taken to produce such earnings. There were line-of-business managers who also were focused on revenue production, and that focus led them to abdicate their risk responsibilities to the Risk Management function. And finally, there were new Chief Risk Officers willing to assume all responsibility for all risk throughout the company.

It is now an accepted fact that casting a Chief Risk Officer in the role of a policeman doesn't work. The CEO and front-office management *must* take first responsibility for risk management, with the Chief Risk Officer playing a supporting role.

To reinforce that outcome, boards of directors must implement a compensation scheme that will incent management to want to understand their risks and to ensure the company is appropriately paid for those risks. We have seen countless instances where front-line managers ignored risks because they had no incentive to do otherwise. Instances of paying short-term incentives for taking long-term risks were plentiful.

The importance of incentive compensation in the management of risk cannot be overstated. It is a key component for reinforcing a risk-focused culture. But such incentive schemes should be designed not to avoid risk, but rather to induce employees to be cognizant of risks they are taking and to ensure the company is appropriately rewarded for taking the risk. A risk-based incentive system helps ensure that the interests of management, shareholders, and depositors are all aligned.

Boards of directors should ensure they have individuals within their ranks who understand financial risk. In the United States, we have laws that mandate Audit Committees to have individuals conversant in financial statements. Yet we have no such mandates for board expertise in risk management, whose absence poses a far greater threat than most accounting errors do.

As a matter of good corporate governance, it seems appropriate for financial institutions to create a committee to focus on risk management, or the *active acceptance of risk by which profits are generated*. That committee would be separate and distinct from the

Audit Committee, which largely facilitates the *prevention of losses arising through operations*.

In the recent market turmoil, we have seen many instances where communication between parts of the company was lacking. For example, lines of business may have provided liquidity facilities for special-purpose vehicles like SIVs. As contingent liabilities, these facilities do not appear on the balance sheet. Often the bank's Treasury Department, which is responsible for ensuring adequate funding, was unaware of such commitments. When market disruption occurred and the liquidity facilities were suddenly drawn, treasurers were surprised and left scrambling to find ways to fund the draws. With the capital markets in a state of disruption, the cost of buying funds to cover the unexpected demand became prohibitively expensive.

Surprises such as these could have been averted through better communication between departments. It is safe to assume that if bank management was unaware of its contingent funding demands, so too was the board of directors. This lack of communication was indicative of a breakdown in the information circulatory system and inhibited management's ability to understand the company's risk profile. Further, if the Treasury people were unaware of the contingent commitments, they were unable to properly engage in transfer pricing, a critical step in ensuring that line managers obtain sufficient reward for the risks they are taking.

What Regulators Have Likely Learned About Risk Management and What They Can Do to Improve Their Response to Future Problems

There are always opportunities to learn from misfortune, and the current circumstance is no exception.

Troubles in the markets were driven by the meltdown of the subprime mortgage industry and its attendant evaporation of liquidity. The depth and duration of the problems can be categorized as a "tail event." The probability of most tail events actually happening is normally low enough to garner little attention from either bankers or regulators. As a consequence, when tail events do happen, they come as a surprise and they tend to hurt—a lot.

Regulators, like bankers, now know that the possibility of tail events must be given greater attention. For several years, regulators have been pushing the industry hard to do more stress and scenario testing. Such testing can reveal damage that could be done by the appearance of a tail event, giving management an opportunity to take appropriate action before the event actually takes place. While some in the industry were slow to respond to the regulatory push on this type of testing, the implosion of the capital markets has given a new sense of urgency.

Regulators have taken a step back to revisit their pending Basel II regulation in order to ensure it appropriately addresses liquidity, concentrations of credit, and off-balance-sheet activities, including those that contain implicit or reputational risks. Further, they intend to develop ways to incent companies to supplement their historical-based risk measurement with forward-looking analyses. These actions are a direct outcome of the problems discovered during the market turmoil.

Beyond Basel II, regulators are also demonstrating a keen interest in other important areas of the risk management business. These would include risk governance, valuation processes, disclosure, and the behavioral aspects of incentive compensation schemes.

With the benefit of 20/20 hindsight, one could criticize regulators (and bankers) for not foreseeing the budding calamity in the capital markets. Most would agree, however, that regulators have played a critical and beneficial role in tempering a situation that was spinning out of control. To see this, one only has to look at the support the Federal Reserve has brought to the investment banking community. Were it not for the Fed's bold actions, our industry—and the economy—might have experienced a catastrophe.

To enhance their ability to react more proactively, regulators could benefit from the medicine they are administering to their constituent banks and develop a more robust system of stress and scenario testing for the industry as a whole. For example, the Federal Reserve is currently analyzing the industry-wide implications of the credit derivatives market, which is an issue that cannot be sufficiently addressed at an individual-bank level. The Fed's effort to understand the "what ifs" of this market segment may enable contingency plans to be developed before a problem occurs. Efforts such as these should be both applauded and encouraged.

The last several decades have witnessed a dramatic shift in where financial assets are held. The commercial banking industry, once a dominant player in managing the country's financial wealth, has seen its market share continuously eroded by other market participants. Investment banks, hedge funds, and private equity investors have come to play an increasing role in meeting the needs of the nation's capital requirements.

This disintermediation from the commercial banking sector is due, in part, to an imbalance in regulatory oversight. Regulators, such as the Fed, were at one time able to claim oversight of a majority of the financial markets. With the emergence of alternative players not subject to their supervision, regulators have lost a significant amount of influence over the behavior of the markets.

Financial services providers on the periphery of regulatory supervision have had both positive and negative effects on the markets. They are less burdened by regulatory constraints, which allows them to be more creative and nimble in their operations. On the other hand, they can also spoil market stability through a lack of discipline.

There is an old adage in the lending business that says, "Underwriting standards sink to the lowest common denominator." Market participants engaging in originate-to-distribute activity sometimes were too aggressive with their underwriting standards. Other market participants were then faced with Hobson's choice of doing likewise or losing clients to the spoilers. Often they followed suit, setting up the next cycle of credit losses. If regulators had influence over a greater breadth of market participants, they might have been able to maintain a more stable environment for all.

Financial institutions themselves could enhance overall governance by adding to their boards some directors who have risk management experience and knowledge. There appears to be a dearth of such experience at the board level right now, which may be contributing, in part, to the industry's propensity to repeat past mistakes. The presence of risk management expertise at the board level would enable directors to ask the appropriate questions of bank management in this regard. Indeed, regulators should encourage financial institutions under their jurisdiction to consider the benefits of such expertise at the board level.

Financial institutions also need to raise the profile of risk management throughout their companies. Until companies transition to a risk-focused mentality in the day-to-day conduct of their business, they will continue to expose themselves and the industry to volatile swings in profitability. Fortunately, a number of steps can be taken to foster this risk-based mentality.

- As previously mentioned, companies can add risk experience to their boards of directors. Boards can set risk appetites for their respective institutions and monitor management's compliance with such guidance. Boards can also assist by creating incentive compensation systems that encourage management to continuously seek to understand the risks they take and to ensure the company is being appropriately compensated for them. Further, they can ensure that the risk function within their organizations has equal parity with other areas of senior management.

- CEOs should relentlessly promote management's responsibility for risk as well as revenue production. A CEO's direct participation in the understanding of risk goes a long way toward emphasizing its importance to members of senior management. (No subordinates want the boss to have a greater understanding of their businesses' risks than they do.) The CEO's personal involvement fosters an environment of open communication, information sharing, and formulation of strategies to deal with real or potential risks. Evidence to this effect was presented in the Senior Supervisors Group paper from March 2008, "Observations on Risk Management Practices During the Recent Market Turbulence."

- Regulators should continue their current focus on risk governance within financial institutions. Regulators have a unique perspective that enables them to see across the industry to determine which practices foster effective risk management and which do not. Generally speaking, they are hesitant to dictate to individual institutions on how the company should be structured and how it should be managed. That posture is appropriate. However, regulators can and should share the knowledge they glean with regard to successful risk governance at institutions under their purview.

- Regulators should increase their visibility with boards of directors and engage in a dialogue with them on risk governance. Doing so will enhance directors' knowledge of sound practices within the industry. For example, if regulators indicate that most firms are moving to establish a Risk Management Committee of the board, it won't be long before outliers move toward conformance. Those that don't will at least benefit from the conversation as to why not.

- Initiatives like the Federal Reserve's effort to get its arms around the credit derivatives market are critical in identifying systemic risks. Efforts such as these should be made a staple of regulatory responsibilities.

- By studying the mistakes made to this point, regulators have identified a number of important areas that need to be addressed quickly. They need to share their ongoing findings openly and to respond with industry guidance of *appropriate* measure. No more and no less.

Summary

The financial services industry is experiencing great difficulty today. It has been battered by a severe liquidity shortage and plunging valuations of market-based assets. Those problems are now giving way to the next stage: deteriorating asset quality, which may result in a new round of credit-related losses.

Many have faulted models for playing a major role in the collapse of the capital markets, but this charge is probably overstated. It is the human factor that played a greater role in the models' dysfunction. Humans built the models, fed them historical data, provided the assumptions to guide them, and interpreted their outcome. As an industry, we now have a greater appreciation of models' limitations and have discovered the need to supplement them with forward-looking analyses.

The discipline of risk management is an evolving one. While many improvements have been made, many more are yet to come. Greater board-level attention on matters of risk will help, especially if driven by board members who are conversant in risk management. Boards need to make certain that management focuses not just on revenue production, but also on the understanding of and pricing for risk the company takes. Key elements that will facilitate such an outcome include defining a risk appetite for the company and implementing an appropriate risk-based incentive compensation scheme.

CEOs must play an active role in advocating the importance of risk and risk management. By witnessing the CEO's interest in risk, subordinates will be compelled to follow suit. Such engagement fosters a healthy exchange of risk information, ideas, and strategies throughout the company. The CEO must ensure that risk management is the responsibility of every employee. Allowing abdication of that responsibility to the Chief Risk Officer is a recipe for failure.

Regulators have already provided many valuable insights into the causes of the market turmoil and are taking steps to respond to it. They are also beginning to focus on threats to the financial system specifically and to the economy more generally. By performing scenario analyses on financial sectors such as the credit derivatives market, they are trying to anticipate problems before they have a chance to manifest themselves.

Regulators have done a noble job of tempering a bad situation, despite having direct jurisdiction over only a fraction of the financial services industry. Changes to the scope of regulatory oversight, some of which have been offered by the current Treasury proposal, may assist in this area.

An increased level of dialogue between regulators and boards of directors on risk governance will help elevate its importance and understanding. Further, with the insights gained from their oversight role, regulators are in a great position to share sound risk management practices throughout the industry.

Although much work needs to be done to remediate deficiencies revealed by the market crisis, all concerned parties must be cautious in their approach. Overreaction can make a tenuous situation only that much worse.

And that concludes my prepared remarks. Thank you once again, Mr. Chairman, for the opportunity to present RMA's comments on this important subject.