As we come out of the recession, with perhaps a period of lower growth and a capital markets environment with lower volatility, business lines will come forward with new products, new initiatives, and new ideas. —Tom Flynn, BMO Financial Group
At a recent Toronto Chapter meeting, Canadian CROs discussed the challenging issues they face, the regulatory framework, the future of the financial services industry, and what it all means for risk management.

BY KATHLEEN M. BEANS

Risk managers face many challenges in the post-crisis environment, but regulatory issues top the list of concerns for Canadian chief risk officers. Their goal is that risk management practices remain effective in a rapidly changing regulatory framework.

“The regulatory bar has risen dramatically over the past couple years, and it’s going to continue to rise, creating a dramatic impact on risk management,” said Mark R. Chauvin, TD Bank Financial Group. He spoke as part of a CRO panel at a Toronto Chapter luncheon attended by more than 400 risk professionals.

The discussion was moderated by Keith P. Ambachtsheer, director of the Rotman International Centre for Pension Management and adjunct professor of finance at the University of Toronto.

As Basel II evolved, new tools and processes were developed for enterprise-wide stress testing. While the CROs believe these advances are good, they worry that institutions will focus so much on the tools that they will lose sight of their primary objective: to manage emerging risk.

“Process is critical to managing risk, but don’t fall into the trap of thinking your risk management is good because you’re using the processes,” said Chauvin. “The challenge is to ensure that the processes yield value-added content that helps us evaluate old risks as well as new ones we may not be aware of yet.”

Brian Porter of Scotiabank agreed. “We can’t bury ourselves in process,” he said. “We have banks to run and stakeholders to look after. We should approach this change in the regulatory framework in a thoughtful, deliberate fashion, which takes time.”

How to take on risk as the recovery proceeds will be the next challenge, according to Tom Woods of CIBC. “After spending two years de-risking our organizations, we now have to determine when and to what degree, and how quickly, to start taking incremental risks—domestically and internationally,” he said. “Risk management needs to work well with our businesses so that we don’t get out in front too quickly or lag behind.”

Tom Flynn, BMO Financial Group, addressed the need for vigilance when the economy gathers steam. “As we come out of the recession, with perhaps a period of lower growth and a capital markets environment with lower volatility, business lines will come forward with new products, new initiatives, and new ideas,” he said. “We have strengthened some of our processes to ensure a good risk discipline in the new product and initiative area to make sure we understand where we’re headed.”

At Royal Bank of Canada, Morten Friis believes it’s important to strike a balance between capitalizing on opportunities for growth and ensuring stability over the longer term. “It must be managed so that if a W-shaped recovery occurs, the institution can live with the consequences,” he said. “If you’re too timid, you’re going to be left behind. If you’re too aggressive, you run a high risk of looking like tomorrow’s fool.”
Performance-based Compensation
As a result of the crisis, institutions are discussing compensation structures, presenting risk management with an opportunity to shape incentives to drive desired behavior.

“In the past, compensation issues were handled at the top end of the organization, and perhaps not with a whole lot of risk management involvement,” explained Friis. “Now, regulators and boards are looking for risk management to be involved in that conversation.”

But how do you compensate risk managers? “Risk management skills are more in demand, so we’re in a better position to attract and retain the right talent,” added Friis. Noting a bias among regulators for long-term incentives, he believes that bias is appropriate at the margin, but it can be an issue in attracting and retaining the right talent.

“Risk management has clearly moved to a different place on the agenda,” noted Friis. “It won’t last forever, but in the near term we have a great opportunity to build the risk management teams and retain talent.”

Agreeing, Woods noted the importance of risk managers’ judgment. “There’s no question regulators would like the risk management department to express a view, but on a fairly formulaic basis,” he said. “But we also need senior-level people in the risk department who can describe how a business performed in alignment with our risk appetite. Judgment is important.

“Within the individual risk groups there is a fine balance,” he continued. “All of us are restricted in linking risk department staff compensation directly to performance of the business. Yet judgment is needed to incent risk managers because it’s important that they partner effectively with the business and assist in reaching its goals.”

New Modeling Tools
Despite the criticism directed at models following the crisis, the CROs acknowledged the importance of these tools as well as their limitations.

“Risk management is a competitive advantage for those who get it right,” said Friis. “There are new advances in how we think about risk, and we’re in constant evolution, but it’s not revolutionary. A few lessons we learned in the last couple of years are just old lessons in new clothing. The trick with new tools and methodologies is to understand and manage the drivers of the old issues and problems—concentrations and volatility.”

Porter described how stress tests—whether enterprise or ad hoc—help set a benchmark. “But it won’t be long before Wall Street or Bay Street invents the next new product or the next best trade,” he said. “It comes down to experience, judgment, and respect for the risk culture in the organization.”

Flynn noted that there is a new appreciation for the basics. “Everybody needs to have a healthy skepticism of complexity. We need sophisticated new tools, and we need to do stress testing in new and different ways,” he said. “But none of that replaces the basics of making sure that people in risk are talking to people in the business about the nature of the risk in the business. The most important foundation you can have is high-quality, frequent conversations about risk.”

Dealing with Low-Probability, High-Impact Events
Events with long tails are difficult to predict, but the CROs build mechanisms such as disaster recovery programs to help them steer through unlikely, high-impact crises. They believe such safety nets should be tested to be sure they are
robust. They also discuss emerging risks, which challenges them to think about what could happen.

Chauvin advised against deliberately taking risks with long tails because they’re hard to measure and therefore hard to manage or to determine if they fit within your risk appetite. He added, however, that “there are certain long-tail risks you should take because they’re fundamental to your business, such as prepayment risk on mortgages.”

Regulation: Where Is It Headed?
Pointing out that regulatory reform is an international issue, Woods remarked, “It may be a little ambitious, though admirable, to think we’re going to get global consensus. A level playing field is important. So it would be a positive development if countries ultimately reached a consensus, particularly on capital and liquidity issues.”

Woods is most concerned about proposed liquidity rules and their ultimate cost. “As drafted, the liquidity rules call for a significant extension in the terms of banks’ financing, and that would have a knock-on effect on returns on equity—I don’t think shareholders will tolerate much of that, if any—or on product pricing and, potentially, deleveraging or asset rationalization.”

He’s optimistic that the international regulatory bodies will find a palatable solution. “We may not get complete consensus, but just as in a basketball game, a lot happens in the last two minutes. The last two minutes are probably still a year away,” he said.

Meanwhile, Flynn noted that, internationally, there is little agreement about how quickly the rules for capital and liquidity should be introduced. He worries that Canada could suffer competitively if it implements changes ahead of other countries that are not fully with the G-20 program.

Flynn is also concerned about the unintended consequences that could result from immense changes to capital and liquidity in the time frame that’s being contemplated. “Will putting too much capital and liquidity onto banks cause banks not to lend, thereby causing the economy to slow and a second dip to occur?” he asked. “Or might it push all sorts of activities out of the banking system into an unregulated environment and transfer the problem?”

Porter and Chauvin would like the regulators to slow down and focus on the key areas that caused the problem. “The U.S. had fragmented regulation and a lack of supervision. Executives and boards didn’t know what was on their books,” said Porter. “We’re not going to change that overnight. It has to be done in a thoughtful, deliberate way so that the consumer isn’t bearing an undue amount of the cost or shareholders aren’t looking at a 10% or 12% ROI, which would be very damaging for the overall economy and the banks individually in the long term.”

In Canada, regulatory enhancements are mostly designed to ensure that Canadian banks stay on a level playing field with increasingly demanding international requirements. “Having internationally harmonized and consistent rules is important,” said Friis.

Looking Ahead
The CROs expressed confidence about their institutions’
ability to remain competitive and to grow in the months ahead. These institutions plan to pursue business in Canada and most are considering global opportunities. None plans to change its strategic focus in the next five years.

Chauvin believes that his bank’s North American strategy provided significant opportunities for growth over the coming years. The key was to remain focused on key strategies, avoid strategic drift (which often results in unintended consequences), and, most importantly, make sure everyone understands and lives within the prevailing enterprise risk appetite. “Risk management must function as a strategic partner with each business if the overall goals of the enterprise are to be achieved,” he said.

Porter addressed the opportunities and risks of pursuing overseas business. “Internationally, we look at countries that are under-banked and that have favorable demographic trends—a young, burgeoning middle class that wants to buy cars, houses, and other consumer products.”

Scotiabank works with Foreign Affairs and International Trade Canada as part of its due diligence for international acquisitions. “We like to be in a country that respects its institutions, whether it’s the central bank or the judiciary or the political process. An independent judiciary is key,” said Porter.

“Within the mature Canadian market are many opportunities for growth,” said Friis. “Building capability in our capital markets businesses has been a significant source of our current and future strength. The wealth-management business is attractive. Cycles come and go. Opportunities come and go. If you focus on your strong capabilities in key areas, you’ll be able to capitalize on opportunities that arise.”

CIBC’s strategy is to protect its base and focus on domestic markets where the bank is under-represented relative to its brand—for example, foreign exchange as well as small business and commercial banking in some market segments. “The challenge is to make creditworthy deals happen faster,” said Woods.

Bank of Montreal is focused on competing effectively across the full suite of products in Canada and the United States and, at the same time, strengthening its risk management around new products. “We expect to have higher rates of growth in the wealth-related business,” said Flynn. “As we introduce innovative products for savings and retirement, we place a higher emphasis on product risk, reputational risk, and fiduciary risk.”

Living Wills
An institution creates a living will by developing a plan to unwind itself in the event that it fails.

According to Porter, all large financial institutions should have reasonable wind-down plans in place because a failure has global, systemic implications. He also believes regulators should have a plan to unwind an institution. In the recent crisis, he said, “regulators didn’t have a game plan, so when Company X got in trouble, they didn’t have adequate appreciation of what to do. They were flying by the seat of their pants.”

Chauvin believes it’s better to focus on controls for liquidity and capital management that would prevent institutions from failing. “The concept of planning to wind down a large financial institution is complex,” he said. “Large organizations operate in various jurisdictions, making them difficult to unwind. Value is lost in unwinding. It’s a Draconian solution.”

Agreeing, Friis said, “The whole idea that we should plan for death may seem counterintuitive, but the problem needs to be addressed. In an unwind scenario, regulators have to take over and wind down an institution, but they don’t know what to do once they get past the front doors. What are the systems you’re operating on? What is the mix of assets that you’ve got? How is this whole institution put together? These are elements of the business that they don’t review in their normal supervisory activities.”

Having a clear view on how to manage through a crisis and understanding what options management has to bring an institution back from a severe stress event are very valuable, added Friis. He noted that the planning effort for an unwinding process can be incredibly laborious, and keeping it current nearly impossible. Yet this, too, can be a valuable management exercise “as long as you do it at the appropriate level of detail, which means not too much. The knowledge you gain will allow you to have a conversation at a board and senior management level as well as at the regulatory level about the stress your structure can bear.”

“The secrets of the risk management business do not change. The challenge is to apply the fundamentals to new situations and opportunities.” —Morten Friis, Royal Bank of Canada
Woods and Flynn see value in the unwind exercises because they push management and the board to discuss the quality of depositors and the credit quality of assets. “But there’s a danger in thinking you’ve got the solution because none of us can predict what the next problem will be,” said Woods.

“The trick is to find the right balance without going in too deep,” said Flynn. “Having 100-page manuals about how to unwind every institution is not productive. We need more of a road map at a high level than we had heading into the crisis.”

**Concluding Thoughts**
Each of the risk officers offered a few parting thoughts to chapter members.

Porter warned that some recent activity in global lending markets is not constructive. “A year ago, I didn’t think we’d see an investment-grade transaction without adequate financial covenants at this stage of the game,” he said. “Some of the kinds of lending behaviors that led to problems seem to be creeping back already.”

“The crisis has been a catalyst for change, much of which has been positive,” said Chauvin. “The last couple of years have taught us a lot. Now there’s an opportunity to improve effectiveness in risk management that will have a lasting impact.”

“Fundamentals matter,” noted Friis. “The secrets of the risk management business do not change. The challenge is to apply the fundamentals to new situations and opportunities.”

Woods advocated that everyone attempt to partner effectively, but also to remember that risk management’s role is to be independent.

Flynn said that regulatory change is a reality. “There needs to be change and the system needs to be strengthened,” he said. “As an industry, we need to recognize that and to play a leadership role in shaping it.”

He also warned risk managers to not become complacent and to avoid the danger of becoming arrogant. “Canada came through this crisis in great shape for many reasons. We need to continue to be vigilant, stick to the fundamentals, and do a good job,” he concluded.

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