Lead Left Interview – Adrian Docherty (Part 2)

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This week we continue our conversation with Adrian Docherty, who heads up BNP Paribas' Bank Advisory team. His team helps banks who are customers and counterparties of BNP Paribas to improve their management of risk, capital, funding, liquidity and profitability. He is also the author of *Better Banking: Understanding and Addressing the Failures in Risk Management, Governance and Regulation*. *Second of two parts – View part one*

The Lead Left: What are your clients doing in response?

Adrian Docherty: Certain business lines are slipping from attractive to unattractive. For example, almost every European universal bank is scaling back. Deutsche Bank, Barclays, Credit Suisse, … Being global is less attractive, less profitable than before. UBS, for example, had a major chunk of their business in investment banking and capital markets, but it's now a mere shadow of what it used to be. Switzerland simply doesn't want to domicile a huge investment bank any more.

Another example is the super-prime mortgage market in Europe. The dynamics of this are unfolding as we speak. How do you work with these risk weighted floors, which vastly increase the regulatory capital needed to run a low-risk mortgage business? There was a leak in the media recently regarding Rabobank is considering scaling back its balance sheet by some 25%. The inference is it may need to become a smaller institution in order to be more sustainable.

TLL: What's the defensible argument for bank risk models?

AD: Risk management is the most difficult thing banks do. They have a lot of experience doing it and generally they've done a good job. I'm a big believer in Basel II, which introduced advanced risk models into bank regulation. Clearly, banks' risk models need oversight and objective supervision. I believe there's a way to make sure that works. Supervision is all too often seen as a poor cousin of regulation, but it is vital and, from what we see, it actually works.

Northern Rock, for example, hadn't had its supervisory visit for eighteen months before it failed, despite its rapid growth and risky profile. Their mortgage products were pretty special. I myself was the beneficiary a Northern Rock mortgage back in the day: it was great to get 7% cash back at the closing! But the existence of those products was really a symptom of supervisory failure.

We've come a long way since then, but we're not there yet. The authorities — the OCC, Fed, FIDC in the US and their counterparts overseas — have all done a fantastic job in building better supervisory structures. We can be much more confident that everyone's numbers have been scrutinized and examined, everyone's business model, management team and risk profile assessed.

I'm confident that better supervision and better governance can solve the issues that caused the financial crisis. Let's take some illustrations. UBS had always seemed to be well-managed. But during the 2005-06 period it was growing quickly, and internal risk management processes failed. They had built up gargantuan exposures in sub-prime, almost accidentally. It was never challenged. Merrill Lynch, another generally excellent firm, had built up similar risk in their CDO books. Management didn't run the business in a prudent way and there was no challenge from the supervisors or the owners of the firm.

TLL: Which again raises the question of the integrity of internal risk models.

AD: When I look at banks' internal risk-weighted models, I actually see well-modeled risk. Let's be clear though: the risk ratings and weightings aren't meant to be comparable. If you lend to Company X, one bank might say it's a 4 and the other might say it's a 5. They might disagree! Indeed, they *should* disagree, that's key to having a market economy. Some are buyers, some are sellers. Heterogeneity is a good thing to have on a systemic level globally. Now if a bank tends to have an optimistic bias across every asset, there may be merit in getting them to rethink that view.

TLL: You've written that IFRS 9 is "bigger than Basel." What did you mean by that?

AD: IFSR 9 introduces complexity, pro-cyclicality, subjectivity, and volatility – all bad. Users of assets want to see financial positions, not subjective measures. I'm really amazed and appalled that the authorities have charged off in this direction. It will create major negative consequences in the banking industry.

TLL: What about the shadow banking system? Don't regulators understand risk is migrating there?

AD: Some developments about shadow banks are great. It's really a catalyst for all of us for positive change. But some structures outside the regulated market look fragile or unreliable. Without being Luddite about this, we should have learned that it's important to have a banking system that's both resilient to shocks and somehow controllable. Dynamism is a good thing, but fragmentation alone isn't necessarily a good thing. Who is managing the systemic risk of the shadow banking system? If there's a run on currency, for example, how will they fare? I'm afraid to say that we will for sure have crashes and failures.

Normally there are one or two new banks in the UK each century. But in recent years, there have been a dozen new banks start operations, with maybe thirty in the pipeline. Add to that the 40 or so platforms for small business lending and 12 peer-to-peer consumer lenders. That's all great for choice and competition. And I hear that these new banks are adopting the best practices of the established lenders in the various areas of underwriting and risk management. Some of these new ventures will succeed, but others will undoubtedly fail. Again, we should probably revisit the lessons we should have learned the sub-prime mortgages: throwing risk out there with people who aren't prepared to manage it, isn't a good thing.

TLL: Finally, Adrian, what's been your biggest surprise this year?

AD: I think it's been the realization that IFRS 9 is a done deal. I recently had a meeting with the CFO of one of Europe's largest banks. He told me, "There's no way this is being stopped. We just have to live with it." Usually there's resistance, but people have given up on that. We're half way up the aisle, everyone seems to be saying, so we might as well get married. I'm also surprised that no-one seems surprised at this!

Contact:
Adrian Docherty
adrian@docherty.com