Comment on the paper by Professor Hellwig «Systemic Aspects of Risk Management in Banking and Finance»

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I am actually very grateful to Professor HELWIG that I received the paper only half-an-hour before the conference. That relieved me of the temptation to try to develop a formal speech and commentary on it. Let me therefore add some more complementary theses on the theme, rather than commenting directly on the paper.

I would propose four theses:

The first is that in my view there are two types of systemic risk; there is a structural risk and there is a crisis risk. The structural risk is the risk that arises from a fundamentally flawed structure in financial services industries such as, for example, the recent S&L’s crisis in North America, or our problems in Switzerland with regional banks. Crisis risk is the risk that arises from sudden events such as Barings, Herstatt, and other crises that we have seen over the past years. These two types of systemic risk require different risk measurement and risk management approaches, and they also require different approaches from regulators.

Second thesis: With respect to the structural risk, there is no way around the problem other than to transform banking into a normal business and – if I may venture to give you one suggestion – it may be appropriate to differentiate your model of the bank (which, if I read your paper correctly) just assumes margin minus overhead costs, into something that better reflects the realities and complexities of the universal bank. This, because if we look at the portfolio of these banks it covers businesses as diverse as retail banking, private banking, corporate banking, global investment banking, trading and so on. And, if, as you rightly point out, deregulation has become a fact and margins have become exposed to competition, banks are going to have to transform their organizations to reflect this business structure and manage themselves accordingly. This, today, is still for several banks not the case. Several do not have clear strategies for single business areas, nor are they organized by business areas which are accountable for their strategies and for their results, meaning for the returns and for the risks. So, if we want to resolve the incentive problem that you rightly identify, we have to find a way within the banks to clearly personify who owns which risk. Therefore, I am always a bit sceptical when professors talk about correlations, because what correlations often do in practice is to dilute clear individual accountabilities. Let me cite one example: even if it is true that

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credit risk and market risk are not independent of each other, if we followed your suggestion to eliminate that distinction, it would be very tough to manage the bank, because it needs different people to manage these different risks.

This leads me to my thesis No. 3. I think capital adequacy is a good way to send the right signals with a view to eliminating structural risk and inducing banks to get organized along their business lines. The precondition that they are reasonable in this sense, is that they not only reflect macro-economic perspectives, but even more importantly, that they reflect micro-economic perspectives. That means that they really approach the individual risk categories in a differentiated way, and even though we are concerned at the cost associated with introducing the new equity requirement rules in Switzerland, we have to welcome them, because, in the end, they really do give a more accurate signal as to how to allocate capital within the bank to where the actual risks are. Secondly, what they should do is not disincentivate the sophisticated banks as opposed to the non-sophisticated banks. Those banks which invest into sophisticated credit rating systems and market risk measurement systems should not be penalised, but rewarded for doing so, and they should therefore be allowed to use their internal systems as proposed in the concepts for market risk capital adequacy. Thirdly, they must be in a reasonable balance to shareholder interest because otherwise, if banks cease to be attractive for private shareholders, structural risk will increase again.

Let me conclude with my thesis No. 4: Regulators have to deal differently with these two types of risk, with structural risk on the one hand, and with crisis risk on the other. To reduce structural risk, the role of regulators together with the external and internal auditors of the banks, should be focused primarily on controlling whether the governance, the strategies, the organizations, the systems, and the processes, are in line with what is required to manage banks along business requirements with appropriate risk/reward ownerships. With respect to crisis management, however, regulators should maybe adopt somewhat more proactive and risk-oriented approaches to get an early enough grip on crises even if that requires a certain shift of focus towards trying to find early warning signals that could lead to indicate the future. For that they should also take into account informal and unconventional warnings, looking beyond the industry borders of banking to include cases such as that of Metallgesellschaft.

I would just cite one good example. I think the path our Federal Banking Commission adopted when dealing with the regional banking crisis was a very good approach to help solve the problem proactively, rather than after the fact.