The global financial crisis has triggered a lively debate over the need to reform the world’s financial architecture to better prepare for future storms. But Standard Chartered banker David Edwards argues that banks themselves could do a lot more to prevent future crises by re-emphasizing the basics of better risk management.

Much has been said about the Bretton Woods system, the Group of 20 leading countries and the future of the global monetary and financial system. Generally, the last G-20 summit in London was considered a success although, of course, the real challenge lies in effective implementation.

But it would be difficult to disagree with the G-20 conclusions: the need to stop protectionism, boost international trade and promote sensible regulations and transparency in the financial system. World leaders have an important role to play in shaping the future of the global financial system, but the private sector should also participate by learning from our experiences and sharing those lessons.

So, rather than talking about the merits of Bretton Woods or the G-20, I would like to...
share some lessons we have learned at Standard Chartered since the crisis first broke. We do not pretend that we have found a magic recipe; indeed we have made plenty of mistakes, but fortunately, no large ones!

As the former Group Head of Risk at Standard Chartered I believe that the management of risk is key to banking and will also be key to making the global financial and monetary system more stable and secure in the future.

Lesson 1: 
If there is one thing we have learned it is that there is no silver bullet in risk management. There is no perfect paradigm. No ultra-sophisticated model that always gets it right. No transaction structure that eliminates all risk. There will always be risk in banking, which is why we need good bankers and good regulators.

Lesson 2: 
We can listen to forecasts but should maintain a healthy skepticism about them. The world economy is extraordinarily complicated and it does not always behave as we expect. The foundation of good risk management is accepting that we do not know what will happen next and that the unthinkable sometimes happens. The reality is that most forecasts in the last few years have been wrong.

Lesson 3: 
Beware of conventional wisdom in favor of diversifying risk. We have all seen charts that show that a diversified portfolio offers a better return for the same risk as a concentrated portfolio. That philosophy drove many banks to diversify their businesses and asset portfolios in all sorts of ways. Credit ratings made it easy. But this mindset missed what happens to knowledge and influence when you diversify your exposure. Too many banks built highly diversified portfolios about which they were ignorant and over which they had no influence. So things went wrong for reasons they did not understand or anticipate. And when things went wrong, they were not in a position to influence the outcome because they were so remote from the original borrower. We prefer a more concentrated portfolio that we really understand. I am not saying there are no dangers to concentration, but the way you optimize the balance between concentration and diversification has to take into account the value of information and influence.

Lesson 4: 
Focus on markets you know well, customers you understand deeply and products you understand fully. Our losses in the turbulence of the last 24 months came disproportionately from the periphery of our activities — from small geographies, marginal businesses, less familiar customers. While you can never eliminate risk, you undoubtedly manage it far better when you are well informed. You need to be very clear about your strategy and be disciplined about sticking to it. This may sound obvious, but nearly every failed bank I have come across was involved in businesses that were not part of its core strategy. It is a constant tension. If you have ambitious, entrepreneurial business managers, they will always be testing the limits. But you have to be prepared to make clear what is “off limits.”

Lesson 5: 
Risks do not sit nicely in the categories with which we are familiar — credit risk, market risk, operational risk and so on. In our experience, risks tend to “morph” into forms you least expect and hit you where you are most vulnerable. What happened to the most banks’ asset-backed securities (ABS) portfolios is a good example. Many banks felt comfortable about the credit risks implied by the ratings of the securities in their ABS portfolios. But they got hit when lack of liquidity drove down their market value, almost regardless of their underlying creditworthiness. While watching for credit risk they got surprised by liquidity risk that in turn created market risk. We need to take a holistic approach to thinking about risk, making sure risks do not creep in through the cracks.
Lesson 6: Another lesson is the use of sophisticated models. Like everyone else, we use sophisticated models to manage risk, particularly in the trading book. However, we need to keep asking basic questions — are we making money too easily? Are the returns too smooth to be credible? To some extent, the regulatory environment contributed to this problem. Bankers ended up focusing on making their risk models conform to the so-called Basel II specifications of the Bank for International Settlements (informally known as the central bank of central banks) rather than focusing on the risk itself. We need to manage the risk, not the regulation. This is a lesson I hope the regulators also learn.

Lesson 7: In terms of operational risks, beware of what at Standard Chartered we call “loose rivets.” Drive a ship through a bad storm and the loose rivets pop. And if your ship has too many loose rivets you sink. Drive a bank through the storm we have encountered in financial markets in the last year or so and every weak or incomplete process, policy or system gets exposed and costs you money. In a sense, what I am talking about is broader than what we normally mean by operational risk. It is more the difference between risk management in theory and in practice. So the lesson here is simple: find your loose rivets before the storm does. And fix them.

And finally, lesson 8: Think balance sheet, not profit and loss (P&L). If there is one lesson this crisis has reinforced it is that if you are running a bank you get the balance sheet right and that then drives the P&L. Doing it the other way round — driving the P&L and letting the balance sheet be an outcome — works when the sun shines, but is a disaster when things gets rough. More than any other type of company, banks are balance sheet driven, and it is perilous to forget that. Perhaps because Standard Chartered has always operated in volatile markets, we never forgot this truth. Throughout this turmoil, whenever faced with a trade-off between near-term profits and balance sheet quality, we favored the balance sheet. And I have to admit that I have been stunned by how few people — bankers, regulators and investors — have grasped that the biggest risk banks run is maturity mismatch, not credit or market risk, but the simple fact that banks borrow short and lend long. Look at all the banks that collapsed over the last couple of years and the most important common factor is this — they got their maturity mismatch disastrously wrong. This does not mean we should not do it. In fact, borrowing short and lending long is arguably the most important thing banks do — because it allows the rest of the economy to do the opposite and by doing so fuels companies and empowers consumers. But it does mean that as bankers we should really be on top of how to manage it. And this — what is essentially liquidity risk — is inherently, intrinsically difficult. But it is what we are paid for.

I do not pretend that what we have learned is rocket science, or something new, but I hope some of this at least resonates, or provokes further discussion. As world leaders prepare to deliberate over more regulations, there are many lessons we from the private sector can share with the public sector. Indeed, while we need to update outdated regulations and promote sensible regulation, we also need to recognize that not all regulations are bad or in need of overhaul. If we in the private sector focus on the basics of risk management, we can go a long way toward promoting a more secure and stable global financial system.

David Edwards is President and CEO of Standard Chartered Korea Limited. These remarks were prepared for delivery at the 5th Jeju Peace Forum in Jeju, South Korea, August 11-13.
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