Worry About Your Own Systemic Risk Exposures

by David Ingram

You would not know it from the news, but in fact, a very large number of financial firms and a few regulators did correctly identify the looming problems that led to the financial crisis and took reasonable steps to avoid excessive losses.

Almost all of the media attention has been on the firms and regulators who missed the crisis until it was much too late. Now, everyone is talking about how to avoid the next crisis and the focus seems to be on the regulators and the largest firms—in short, those who got it wrong just a few years ago.

But if you are not someone who is in charge of a major financial system, you should be focusing on those who got it right and discerning what you could be doing to prevent your firm from experiencing excessive losses in future crises. *This article is NOT written for the Chairman of the Fed, or the head of the ECB, IMF or World Bank.*

Systemic risks

For the financial system to be disrupted, two things need to be true:

1. There needs to be an exposure that everyone believes or suspects will turn into a loss of an amount that exceeds the capacity to bear losses of a large number of participants in the system.
2. There needs to be either a high degree of interdependency in the system or else widespread direct exposure to the loss-making large exposure. The system may seize up because the losses are known and the institutions are known to be insolvent or more commonly, because the losses are unknown.

Unknown losses can potentially bring the system to a halt at a much lower amount of loss than known losses. But withholding information about the exposures and the losses is a very common strategy that firms employ when (a) they are not completely sure about the amount of their losses, or (b) when they are sure, and they are insolvent.

The emerging risk approach

Financial crises and the associated systemic risks can be treated in exactly the same way as any other emerging risks. Emerging risks are those risks where there might be a very large potential adverse impact but where frequency is either unknown or presumed to be very low. A typical emerging risk management process would involve:

1. Brainstorming potential risks
2. Choosing risks for further work
3. Identifying the potential impact of selected risks
4. Determining the drivers of risks and potential risk mitigants for those risks where impact is seen to be of concern
5. Identifying leading indicators of increasing likelihood of occurrence
6. Developing a plan for adoption of risk mitigants if/when certain likelihood indicator triggers are met
7. Monitoring risk indicators
8. Testing risk mitigation plans (if possible)
9. Repeating the cycle periodically

This type of process could easily be applied to potential systemic risks. Remember the two issues mentioned above that are needed for a system to be disrupted. The emerging risk that one is looking for in this case is one that could create a massive loss among highly interconnected firms.

The exposures that led to the losses which created the systemic problems in 2008 and the rush into tech stocks in 2001 both seemed to be good business choices prior to each

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crash. But it is only by employing emerging-risk thinking that the risk manager can view the market from the outside and see if anything is amiss.

Right now, there are at least four possible sources of next systemic problem: sovereign debt, especially that of the weaker Eurozone governments, Chinese real estate, U.S. commercial real estate and the additional U.S. mortgage loan losses that are still not being recognized. These processes for identifying potential firm exposures to loss from these sources can and should be employed by firms. The steps that can be taken if identified in time could make the difference between a bad quarter and participation in the next round of bailouts, if there is one.

Systemic counterparty risk

Most efforts to protect a firm from systemic risks should be focused on direct exposures to large risks that might become a trigger for future systemic problems. But the other major source of systemic risk exposure is through counterparties. Avoiding excessive exposures through counterparty due diligence is a major source of pillar three market discipline. Fleeing over-exposed counterparties is usually seen as a very last stage gambit in an impending systemic breakdown. But if in the future firms are serious about avoiding systemic losses, they will lighten their exposure to the counterparties who are over-concentrating on the risks that are most likely to be the next systemic problem long before the classic rush for the door.

Bubbles

One of the major shortcomings of neo-classical economics is its blindness to asset bubbles. Two major asset bubbles happened in the past 10 years. Both were completely missed in advance because of an underlying approach that is based on the assumption that market prices MUST be correct. Because asset bubbles are quite likely to be at the heart of future financial crises and systemic risks, it will be important for firms to develop their own indicators for asset bubbles.

One place to look for help with developing a process for identifying potential bubbles is the 2000 book Irrational Exuberance by Robert Shiller. He devotes over 200 pages to identifying the tech market bubble of the late 1990s while it was still forming.

Note however, that the tech bubble did not create a market disruption. It was more than large enough, but the exposure to the assets was not concentrated in the banks. Insurers held very large positions, but not large enough that the drop in stock prices disrupted the insurance part of the financial system.

Systemic loss tolerance

Together with the board, management must decide between maximizing profit as the next bubble forms and protecting against losses when the bubble eventually pops. Actions that provide protection against losses from the popping bubble will limit the degree to which the firm enjoys the full gains on the upside. CEOs of some banks that were active in the sub-prime mortgage securities that were the trigger for the financial crisis claimed that if they had restrained their bank's activities in that market, the lower profits that they would have reported relative to their peers would have resulted in their eventual removal from their positions.

The emerging-risk approach described here provides a forum for bringing the potential downside from some new rapidly growing opportunity into the risk discussion. A risk tolerance for each emerging risk can be established as a part

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of step six in the emerging risk approach. The tolerance can be established in relationship to some pre-determined stress test so that if exposures grow rapidly due to explosive growth of that risk in the marketplace, the tolerance may be breached, triggering the planned mitigation steps.

With that simple extension of your definition of emerging risks to include large systematic risks, you may be able to help your firm to stay on the right side of the next systemic crisis.

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