

Philip D. Sherman
Philip D. Sherman Consulting LLC

3 Brooklands 2H

Bronxville, NY 10708

E-mail: psherman@shermanfincon.com Tel: 1-914-255-0890

Basel Committee on Banking Supervision

C/O Bank for International Settlements

Basel, Switzerland

Re: "The regulatory framework: balancing risk sensitivity, simplicity
and comparability," Basel Committee Discussion Paper, July 2013

Abstract

This paper suggests, in the context of the Basel Committee's consideration to simplify its current regulatory model, that much more emphasis be given to "portfolio management," broadly defined to include both actual risks and the way risk is accounted for and managed as well as a deeper assessment of portfolio concentrations which are the root cause, when they go wrong, of financial problems either at an individual institutional level or a market level. Over time, such an approach will cause banking management issues to be more accessible at all levels of the financial system and overall society and strengthen the management both of the financial system and the economy. This will be because bank management and its constituencies will focus on what businesses banks are actually doing, as opposed to the more abstract issue of bank earnings. A portfolio management approach "puts risk first."

Gentlemen:

This a remarkable "official" document in its frankness and openness. I write as an experienced banker and consultant who likes the existing "Basel system" but believes that, although its components should largely be preserved, it needs to be re-configured with a strong emphasis on portfolio management thinking in order to serve the various purposes to which it is being put.

The current Basel system attempts to align regulatory requirements with how banks actually manage their affairs. This is the cause of undue complexity. Without removing risk weighting from the concept, I believe the Basel system should be aligned with the needs of regulators and government for macro-economic management, rather than banks' micro economic management which is their own responsibility subject to supervisory requirements.

The purposes of any financial regulatory system are to help provide for financial stability by ensuring that as much as possible the institutions

- Are conservatively managed in context of holding public franchises and that
- The institutions have enough capital to survive either in the event of problems “at home” or problems arising from the operation of the market as a whole which may or may not be a function of a single institutional failure.

As is well known and I think agreed:

- Liquidity issues are more or less invariably the efficient cause of banking or banking system collapses
- Over-concentrations of risk (i.e., inadequate diversification), which turn against the risk-taker(s), are the longer run cause of failure, mainly because they increase vulnerability to liquidity runs but of course ultimately by compromising solvency.

I define “diversification” as the degree of an institution’s exposure to adverse developments in various independent risk factors or “sensitivities”, mainly although far from entirely external to the institution. The purpose of “portfolio management,” which covers all of the risks an institution takes, and how it takes them, and not just credit as had been traditional, is to limit the degree of “factor sensitivity” to levels which are consistent with its managerial capabilities and its resources, including capital, staffing, technology and process. The current Basel system pays some attention of portfolio management, but is more based on the control and aggregation of specific risks, with inadequate consideration of cross-overs between the various categories of risk that are covered. For example, Asian banks actually made money on their FX operations in 1997-8 since they were more or less invariably long USD, but lost a great deal of money directly and indirectly in their credit portfolios due to the steep declines in FX rates vs. local currency. U. S. banks and investors suffered greatly in the Financial Crisis due to inadequate credit process and operational back up which are classified as operational risks but only arise (or, better, are not adequately managed) because of poor credit underwriting.

The Basel system, with its concentration on individual credit transactions, was formulated at the end of what I will call “the heyday of commercial banking” and reflects the conviction of that time that responsible bankers who originated good transactions would create institutional portfolios that more or less took care of themselves. Basel 1 did not really address portfolio management at all, and Basel 2, although the Credit Principles did cover portfolio management and there was/remains a separate set of rules of concentrations of risk to individual obligors, continued this low degree of emphasis. One’s suspicion is that, because correlation is quite hard to measure if not impossible, the Committee stayed away from it as well as the potential that correlation analysis would be used justify reduced capital.

The financial world has changed a lot since Basel 1 and the rudiments of the Basel 2 configurations were created. These developments increase the need for a portfolio management-based approach which focuses on concentrations broadly defined and how risk is actually managed.

- Financial markets are orders of magnitude larger, with attendant effects on institution balance sheets and risk profiles, both on the banking and investor sides.
- New instruments, notably credit derivatives, have been introduced which carry product risks significantly incremental to traditional credit extensions such as loans. These risks include

opacity, margin requirements and the inability to sell them off, leaving hedging as the way to manage some of the risks contained in the products.

- A large increase in the portion of assets that banks must mark to market, which in effect decreases the level of patience in the financial system, which has been a positive system characteristic the virtues of which can be exaggerated but which is essential for stability.
- A change in the ethos of the financial markets toward (frankly speaking) greed and a disrespect for regulation and the public good. (The current ethos has taken quite a while to build to its 2008 crescendo. The change in banking culture is one reason why I recommended separating the best practices Principles documents from the supervisory material and giving it more emphasis to be absolutely clear that good management is the bedrock of banking stability and success.)
- A concentration of the financial system, especially with respect to taking market risk.

All of these factors suggest that the regulatory system has to focus on “the big things,” which are risk concentrations both in individual institutions and in the markets as a whole, covering all major risks and paying particular attention to their inter-relationships including especially with liquidity. The current “bottoms up” system, which is meant to conform to the way banks actually manage themselves, is overly complex and not adequately oriented to “the big things.” My specific recommendations are:

Specifically:

- Portfolio management should be reconceived in a much broader sense than at present in order to integrate risk assessment *per se* with the ways risks are accounted and managed in given institutions and transactions are structured and collateralized.
- Reporting requirements under the current Pillar 3 should be changed in ways that I have recommended and published in downloadable/manipulable form on banks’ websites.
- The Principles and other materials related to Pillar 2 should be altered and expanded to deal with portfolio management issues with much more attention than at present. (It might make sense to set up a separate Basel Pillar, “Management,” to separate it from the thrust of Pillar 2 on “supervisory” matters since the attachments to Pillar 2 actually constitute a compendium of best practices for many aspects of banking that could be expanded on a stand-alone basis.)
- Over time, capital requirements should be evolved to reflect actual portfolio structures and concentrations above and beyond the relatively simple ties to gross risks and risk-adjusted totals although both of these, the “capital” and: leverage” ratios will have their place.

These recommended changes, in my view, will improve the accessibility and comprehensibility of the system in fundamental ways (although not in volume of information required) whilst preserving its values. Portfolio management provides a language which can be applied at all levels of the financial system and amongst the general public in ways that the current approach embodying effectively abstract numbers cannot.

This is not to say that the Basel system should be scrapped --- especially if somewhat reconfigured, the Committee’s requirements and doctrine add up to a decently complete compendium of financial institution best practices which should be followed and augmented at the individual institutional level.

In recommending a portfolio management approach, I do in fact retain the principle that regulations should be in accord with the way banks should be managed. As per the article draft I attach as Note 2, I

see Portfolio Management, properly structured to cover both external and internal factor sensitivities, as the central activity of bank management. I believe that the approach leads to simpler and clearer communication within a bank management, with its Board and with its various publics including but not limited to regulators. Portfolio management is of course information intensive, and the major improvements in financial institution information gathering which have been stimulated by the Basel Committee's approach in principle make my recommendation feasible. Moreover, good portfolio information easily segues into the stress testing process and then budgeting. This accomplishes the goal of tying banking management to capital requirements in a very useful way, and promotes "risk first" thinking.

It is often said that we manage what we (can) measure. Historically, the kind of information on portfolios and the business has fallen in the context of the 1980s book, "What You Always Wanted to Know about Sex but Were Afraid to Ask," i.e., available information would be difficult to find and stale and inaccurate when produced. I think that era is ending and the Committee can move forward with some confidence.

My initial brief suggestion for the actual structure of portfolio reporting is contained in Note 1 attached. Should my suggestion be of interest to the Committee, I would be happy to provide more detail. I would suggest that the information be made available to the public as well as to regulators on the bank's website in a technical form that third parties could manipulate. I appreciate that a lot of data would be required, but note that

- Under Basel 2, banks have made a lot of progress in data management
- New technology should further facilitate data collection and aggregation

I understand, however, that the classic problems of data management – clear definitions consistently applied -- remain as "non-trivial" issues.

Sincerely,

Philip D. Sherman

Note 1 – Portfolio Analysis Structure

I would structure the macro portfolio analysis presentation broadly as follows. It should be made possible (by structuring the data base or using more modern search technology) that all terms can be viewed relatively to all other terms so that “portfolios” can be conceptualized beginning with any of the various portfolio and risk characteristics collected and then subdivided by any other characteristics. For example, a borrower could be viewed (for example) in terms not only of the industry risk, but also

- What are their principal factor sensitivities?
- What collateral is available if any?
- How they are accounted?
- Whether they are operationally intense?
- Whether they are managed by models or discretion?
- And by executives with high or low bonus compensation.

Other examples would be to look at the overall collateral portfolio (including actual real estate loans and companies whose shares are taken as collateral) to ascertain concentrations in this “second way out” portfolio. Or, as suggested below, risk rating the ALM maturity analyses.

The portfolio should be aggregated along three vectors:

- Nominal assets
- Risk weighted assets
- Capital allocated, which is the only way to capture total risks since not all businesses have assets and for markets business which do, “assets” do not necessarily correlate to risks. There might be an unallocated portion of capital. Allocation would reflect outstanding risks, not the internal limits for its use.

A quarterly analysis should work for most banks, but major trading institutions should also show market risk on a quarterly average and high/low basis.

The institutions should publish regularly and the regulators should use the analysis they facilitate for setting up stress tests and, judgmentally setting a general level of capital with the proviso they could ask for more from an individual institution (as they already can). I do not provide a detailed data presentation model but that can be done. Definitions would need to be detailed, but not by a lot I think.

Credit Risk

Clientele

- Top 1000 global companies – same list for everyone covered by Basel
- Major national companies
- Middle market
- Small business
- Consumer business
 - Credit Cards
 - Mortgages
 - Conventional cash flow based secured mortgages according to regulatory definitions and rules

- Mortgages equivalent to the subprime structures
 - Jumbo mortgages
- Other
- Private client financing (integrated with lending to their companies)
- Commercial real estate
 - A couple of categories --- this is a critical area for monitoring
- Financial institutions – including counterparty risk --- some sub categories
- National governments
- Sub-national governments
- Others

Products

- Loans with tenor breakdown
- Credit commitments
- Debt securities with tenor breakdowns
- Credit derivatives
- Counterparty risk with tenor breakdowns by general type
- Other

Security

- Clean
- Trade and current assets
- Property (integrated with real estate book as well as shown independently)
- Plant and equipment
- Securities and other “mark to market” assets
- Other

Accounting (i.e., how the credit risk accounted for?)

- Trading book
- Banking book
- Other

Valuation categories

- Level one
- Level Two
- Level Three

Industry (broad SI Codes – ideally countries can agree to a global set of codes to avoid confusion))

Factor sensitivities (examples)

- Highly leveraged (i.e., interest sensitive if floating)
- Foreign currency exposure (probably at obligor level if a group)
- Operational Intensity -- how much administration enquired
- Political sensitivity
- Export orientation

- Energy dependence (supplier or user)
- Whether primary “first way out” is from a an obligors:
 - Asset turnover, i.e., traditional working capital financing
 - Cash flow from business operations or personal earnings
 - Conversion of assets which are subject to market values

Credit evaluation methodologies

- Conventional analysis
- Actuarial models
- Other models

Compensation of management

- Portfolios managed by people with large bonus or commission component to compensation
- Low bonus or incentive compensation

Market Risk Portfolios

Show by nominal contract trading volumes (i.e., turnover) and outstanding's, net positions (probably at portfolio levels only, not for individual instruments), “Basel” Pillar 1A Capital Employed, Value at Risk (same rules for all banks) for quarter end, quarterly average and high and low exposures during quarter. Obviously quarter end figures must reconcile where appropriate with credit portfolio report.

- FX (USD, EUR, Local Currency, combined others) –
 - Instrument
 - Cash holdings
 - Outright forwards
 - Futures
 - Options
 - Swaps
 - Other
- Fixed income securities (same currency breakdown -- credit details covered in Credit Section. Add instruments and risks as appropriate)
- Equities
- Commodities
- Credit derivatives (detailed actual credit risk covered in credit portfolio section – this aimed at trading positions, i.e., trading account only.)
- Margin – margin paid, margin taken, net margin

N. B. I am less familiar with market risk as practiced today and leave brief details only

Operational Risk

Define portfolios as parts of businesses with differing operational characteristics that can then be related back to the credit and market risk portfolios. Each credit and market risk portfolio can be characterized from a number of operational characteristics including:

- High transaction volume operations
- Low transaction volumes

- “Low ticket” transactions
- “High ticket” transactions

- High dependence on automation
- Low dependence on automation

- Complex transactions
- Simple transactions

- High volatility in terms of asset valuation
- Low volatility in terms of asset valuation

- Local currency only
- Local and foreign currency

Other descriptors can be added over time

Liquidity

Sources of funding should be analyzed by customer/counterparty markets, instruments, use of collateral and other factors. This is a well-developed subject and will change with Basel 3 requirements. My recommendation would be that banks should risk rate their ALM analyses, i.e., which is the average risk rating (since ALM is done only in nominal terms) of the various buckets

Other

This would certainly include exposures by country combined with some of the risk data set out above. It should include businesses which do not necessarily generate significant “bookable” risks, such as mortgage servicing and investment management, “other” activities which involve measurable income flows or risks that are not strictly “financial” even if risk failures cost money. .

Note 2 – Draft of Article on Portfolio Management

“The Queen of Sciences” 8.0

In the Middle Ages, theology, the scholarship of divinity, was characterized as “the Queen of the Sciences.” On a decidedly lower level and in these days, that designation should be given, for financial institutions, to Strategic Portfolio Management. At a time when it is again clear that risk management should and is required to be at the center of banking management, the thinking and disciplines involved in Strategic Portfolio Management (which of course includes the tactical implementation of portfolio strategy guidelines and limits) are exactly what is needed to shape institutions to provide the financial services society needs at risk-adjusted returns sufficient to attract adequate private capital. In short, “Portfolio Management” is the first requirement for the “Manage Risk First” world where earnings are seen to arise from risk-taking. This is a “risk *then* reward” approach, in contrast to the frequent practice of focusing on earnings and treating “risk” as a constraint to be “gotten past” independent risk managers and boards.

The context for portfolio management, as Som-lok Leung, Executive Director of IACPM often points out in presentations, is that it is essentially a “losers” game which is “won” by managing the downside. This of course applies most of all to credit extensions, where upside returns are more limited than downside risks, but the “loser’s game” metaphor applies as well to other financial institution businesses. Some of the largest losses recorded by banks have been due to operational risk issues, sometimes in the trading room, and often in the sales force. In this context, banks must be run to provide service and earnings but always with a view of controlling the downside through exposure control (i.e., well-structured diversification which controls exposure within the business, staffing, process and technology mix the institution chooses to implement) as well as strong processes to control actual transactions, whether loans, trades or client services.

“Portfolio management” at banks has had a lot of intellectual development under the influence of “Modern Portfolio Theory,” which is based on the equity markets and involves substantial quantification. This has been adopted in corporate and consumer lending. Without minimizing the value of such quantification --- which often is presented with more confidence than the underlying data will currently support – the argument here is to return to an older, more craft-oriented approach which yet takes advantage of large improvements in information gathering and processing technology as well as quantification. The approach reflects that banks are actually “businesses” for which there no “market indices” are and which cannot be managed with the fluidity of stock portfolios since they incur many more than only price risks, and face business issues and constraints, putting a strong emphasis on a planning approach. The skeleton argument is as follows:

1. The expression “portfolio” has to be broadened beyond the conventional definition based on assets or, latterly, risk exposures. For example, banks should measure “portfolios” in terms of how the various conventional groups of assets are managed or accounted and set limits accordingly. Both for risk *per se* and risk according to how they are accounted for and managed. Equally liabilities and, of course “ALM,” the balance of assets and liabilities which must contain a credit and operational aspect rather than only maturities (contractual or statistical) and interest

rates. Under this broader definition, banks should be viewed as complex portfolios of complex portfolios

2. These variously defined "portfolios" need to be managed from a risk perspective. The key to managing from a risk perspective is intelligent and broad-based diversification, complemented by excellence in actual transaction management ("origination" and "maintenance.")
3. To ensure diversification on all pertinent vectors, portfolio management must take a "Big Data" approach, spanning siloes and using all possible internal and external sources of pertinent data, both in a qualitative and quantitative sense
4. Portfolio management must be led by the CEO since it determines the institution's actual risk and earnings profile and ultimate ability to survive. It provides a language accessible to all the internal and external constituencies for understanding the institution's business.

This is an approach in principle --- organizational and informational constraints remain very large although institutions are making substantial progress in covering gaps. The base point is that Strategic Portfolio Management covers all of the activities of a financial institution and uses quantitative techniques such as risk rating and stress testing to support and not substitute for management knowledge, experience and common sense and senior leadership...

1. Definition of "Portfolio"

To develop the process for management of diversification at the level of the institution as a whole, we should view it a series of interlocking portfolios including the following which are divided by familiar factors such as client markets, types of products and services offered but, very importantly, also by the way risks are taken and services provided and by whom. A financial institution is a complex organism and should be viewed from different perspectives simultaneously and not in simple "industry exposure." terms most often associated with credit-oriented Portfolio Management. The objective is not to manage only credit exposures but the whole complex of assets, products, risks and business methods.

- Client markets
- Products and services
- Credit extensions and securities investments
- Counterparties
- Trading businesses
- Service businesses
- Risks depending on valuation as opposed to cash flow only
- Sensitive exposures, i.e., risks and businesses with entities and clienteles, or in products, that have or made lead to legal or more generally "political" clashes with third parties including both official and unofficial.
- Collateral, which supports the above credit, trading and services businesses in varying degrees
- Liabilities, including all types of information about providers similar to information of borrowers and risk counterparties.
- Geographies and sovereign (including regulatory and supply chain) risks
- How business is done and how the involved staff are compensated
- Accounting treatment (accrual vs. MTM, and the three levels of valuation estimation)

- Model dependencies
- Relationship of nominal to risk-weighted assets and other comparative risk measures.
- People and skill dependencies
- Competitors (using behavioral theory as well as more experiential observations) and the overall “banking market portfolio”
- Volatility which may include operational processes
- Physical events which impact both the clients and the operations of an institution
- Organizational units. (One advantage of having a good data base that covers the variables, of course, is the ability to avoid having to all reports in organizational terms. Although “organization” is an essential ingredient to managing the institution, specific risks are not confined to specific organizational units (although they may materialize in different ways, as with the impact of high volatility and trading and operational effort rates) and need to be looked at institution-wide.)

The list is illustrative. It can and should be much longer.

We know very well that there are substantial correlations between these “portfolios” defined in accordance with one or more of the above dimensions simultaneously. Although we would like to give much emphasis to quantification of the correlations, the key is actually just identifying them, which mean production of large and potentially complex matrices and maps, even in fairly small institutions, in order to identify “concentrations” where losses across the system could be much larger than realized. Asian banks in 1997 found that their main FX-related risk arose in the credit portfolio. Immediately for foreign currency borrowers and over time in respect of real estate and real estate collateral. . Texas banks saw the low oil prices of the late 1980’s hitting their retail and property development clients and, of course, manufactured housing, a retail business.

The key is to identify the “factor sensitivities,” i.e., the independent variables that affect all of the bank portfolios but in different ways at different times, and “testing the book” – both qualitatively and quantitatively -- to ensure that it will not be hit too hard by an unpredicted (probably large) change in one or more of the independent factors and/or that the institution is prepared for potential trouble, for example by strengthening processes and work forces. The recent emphasis on stress testing, even though focused on conceptualizing adverse scenarios and identifying potential “black swans,” supports this approach. Questions must be asked and scenarios described prior to any necessary quantification. However, this is a mainly job for knowledgeable people and not mathematicians since the purpose is not “portfolio optimization” in the pure Markowitz sense, but risk limitation and proactive management consistent with the institution’s risk appetite, which now is also a formal regulatory requirement even though this is what institutions should always have been doing. (In a way, “portfolio analysis” and even “Portfolio management” could also be described as “structuring stress tests,” although that is only part of the game. Acting on the results is what ultimately matters.)

“Factor sensitivities” are usually viewed as economic or social factors such as interest or foreign exchange rates or political developments that arise outside the bank. However, internal factors, such as compensation practices, training levels, accounting approaches and the like can also be treated a factors independent of the performance of the portfolio which lead to results.

2. Managing from a Risk Perspective – Diversification

The essence of good portfolio management is to understand the areas where there are common factor sensitivities, whether external or internal of the institution. Although such correlations may sometimes be quantified, the real key is their identification. For example:

- An occupational breakdown of a credit card portfolio compared to an institution's corporate credit portfolio will yield much insight.
- A usage and value based map of all direct real estate exposures in all parts of the institution, together with all the property taken as second-way-out collateral (in pastels) will say much about the overall position.
- Risk rating (and perhaps sorting by client leverage levels and an institution's percentage of client liabilities)) the ALM asset side will complement studies of depositor behavior in different scenarios, which of course also affect asset liquidity. It is especially important, for example, that dependency for short-term liquidity not over-depend on repayments by low rated clients who may have to roll over.
- How much risk and revenue is operationally intense in various ways. In which portfolios will operational efforts subject the institution to adverse regulatory or public attention?
- How much of the portfolio is controlled by staff subject to significant bonus compensation will say something about potential volatility
- Which business are valuation-based, use models extensively and are managed by executives on incentive compensation?
- Which components of industry and consumer portfolios and businesses are interest rate sensitive despite their subsectors' not being generally seen in this context
- Portfolios with large nominal values, low risk-weighted capital requirements and a bonus culture in the management should get structured attention.

This too should be a very long and changing list – but it is not exceptionally difficult either to conceptualize or for non-technical people to understand. Indeed, thinking through the connections is what senior management is supposed to do based on their depth of experience. A structured program will force the activity, as for example the “Windows on Risk” which ran for some time at Citigroup.

Although Markowitz investment portfolios can often be easily reorganized in liquid markets, bank portfolios represent businesses and are therefore “sticky.” Progress has been made in terms of liquefying both consumer and corporate banking assets, netting and other such agreements can reduce absolute risk levels. Collateral is being used to reduce risk (although the ways in which acceptable collateral is marshaled can themselves be risky – institutional liability structures based on pledge of the risks the institutions are financing, as we saw in 2007, are intrinsically complex and potentially shaky.) Given these realities, Strategic Portfolio Management must be above all a planning and budgeting, limit and guideline setting and stress testing process that looks to the medium term and ensures that the institution deploys adequate resources – people, processes, technology – to manage the risks involved. Portfolio limits, and details as to acceptable risks and transaction structures within that envelope (“Risk

Asset Acceptance Criteria” or RAAC as my old employer Citibank called them.) No plan, of course, is sacrosanct and there must be an active risk management process which focuses on changing conditions (vis-a-vis previous assumptions) which may dictate changing portfolio solutions at paces ranging from asset sales and hedging to serious resource reallocation.

An intensely information-based portfolio management system is, however, as much an operational tool as a planning tool. As market and other conditions change, banks should be asking questions about all the components of their overall portfolio that reflects current developments. Knowing answers will greatly help in adoption of risk management measures to improve the quality of exposures as well as to limit them. Management needs to say, “This is what is happening, what we should do in respect of the risks we have, or intend to have?”

Although we of course always want to resist “bureaucracy” and “checklists,” which this framework suggests could be a problem, we must remember that these relate to the systematic approach laid out in the diagram below which is key to good risk management, for the same reasons as the medical profession is pushing forward in the same context. There will always be “art” in portfolio management as in medicine, but all the great artists of which I am aware, no matter how irregular their day-to-day lives (e.g., the Italian Baroque master Caravaggio, who was accused of murder in a tavern brawl), had a strong process by which they went about their work.

An advantage of the more qualitative approach to portfolio management is magnified in the case of smaller banks which may lack sophisticated risk analysis systems, but have probably more concentrated risks due to their smaller market areas and more personal knowledge of details by management.

Box -- Implications of Liquidity Management/Requirements for Strategic Portfolio Management

One new aspect is the return of regulatory requirements for holding of liquid assets. Beginning the 1960s with the Euromarkets and the negotiable CD in the U. S., the concept of “liquidity” gradually moved toward “market access” rather than “marketable assets.” To some extent this was undergirded by separations between markets for different instruments and investor bases. In 2007, we saw this end -- the funding market is definitively all one and the idea of a “portfolio of funders” has declined. Still, although attitudes amongst depositors and other investors may have consolidated, the environmental factors impinging on various types of lenders to the market have not consolidated, so portfolio management of funding is just harder to do but perhaps even more essential, the more so as regulators tend to inhibit cross-border and intra-institutional funding and liquidity has a real cost in terms of foregone returns.

Partly because of the regulatory liquidity and nominal leverage requirements, but even more in order to ensure a clear picture, all portfolio information and limits should be gathered and expressed both in nominal and “risk-adjusted” and/or other calculated terms such as sub-portfolio or asset-related RAROC. Equally, portfolio analyses need to be done with regulatory accounting in its various forms. The virtue of “nominal,” in addition to reflecting the proposed general leverage based regulatory rules, is that it is easy to count, and limits can be made clear and easily enforced. (Indeed volume limits are a long-standing basic control – sand is not inherently risky, but forty tons of it in one’s backyard with a big storm coming up, is not something most of us would like to have.) For some kinds of risk, e.g., volatility or convexity, I appreciate there may be really no “nominal,” but that is a risk characteristic of which

management should be aware and certainly the size of the sub-portfolio in which such risks are being incurred should be understood. Using earnings characteristics, of course, supports “risk first” budgeting.

The proposals here, of course, mean that there will be several simultaneous views of the balance sheet, especially at banks with large trading positions, but the reality is that today’s banks need to be viewed as “multidimensional polyhedrons” and the key for management is to understand the interplay and, within the limits of our four-dimensional world concept, to display it.

3. Data-based Approach

Technically this kind of analysis is not difficult, but of course it requires large and efficient data bases, which must be “filled in.” Most banks review most risks at least annually and keep “scorecards” and other data summaries so that over time, the large data bases already required for many purposes can be expanded and, more importantly, integrated. The Basel Committee’s “Principles for effective risk aggregation and risk reporting,” January 2013, is pertinent here although as can be seen, more or less any kind of bank data can and should be used for risk management purposes, and not just the end results of running specific models. (See box for “Portfolio Management in Basel Context.”) Many useful analyses do not require daily data feeds so work-around’s can be designed if needed. No one would claim, however, that information gathering is either easy or near to being perfected.

An aspect of support for Strategic Portfolio Management which is not to be underestimated is the display of results. The theory and a lot of good examples are nicely set out in the collected (and elegantly presented) works of Edwin Tufte (www.tufte.com) and in work Prof. Sam Savage at Stanford has presented to GARP audiences. Although matrices are the basic presentation tool, there is a lot more than can be done.

Equally, although portfolio planning including stress testing is not generally a day- to-day activity, institutions need systems that can calculate out scenarios and stress tests rapidly so that even senior management can hold “real time” discussions of the portfolio and not have to wait more than minutes for results to be calculated and displayed. Like information-gathering, this is a non-trivial issue.

4. Top Management Leadership and Organizational Development

This way of thinking about Strategic Portfolio Management has clear organizational consequences:

- The CEO, who clearly does not have the time and often not the technical ability, to serve as “Chief Risk Officer,” must clearly serve as “Chief Portfolio Officer,” shaping the institution and its strategy and using the various levels of Strategic Portfolio Management language to communicate with a modern financial institution’s many constituencies.

By participating actively in the critical management activity, the CEO will set the tone, shape and build the culture, “walking the talk” to ensure that the institution truly does put risk first. A critical aspect is to understand and enforce the difference between complying with regulatory rules and gaming them. The Salz Report to Barclays Bank has put the issues of leadership and culture before the market. I think that institutions both can and must be led from the top, and

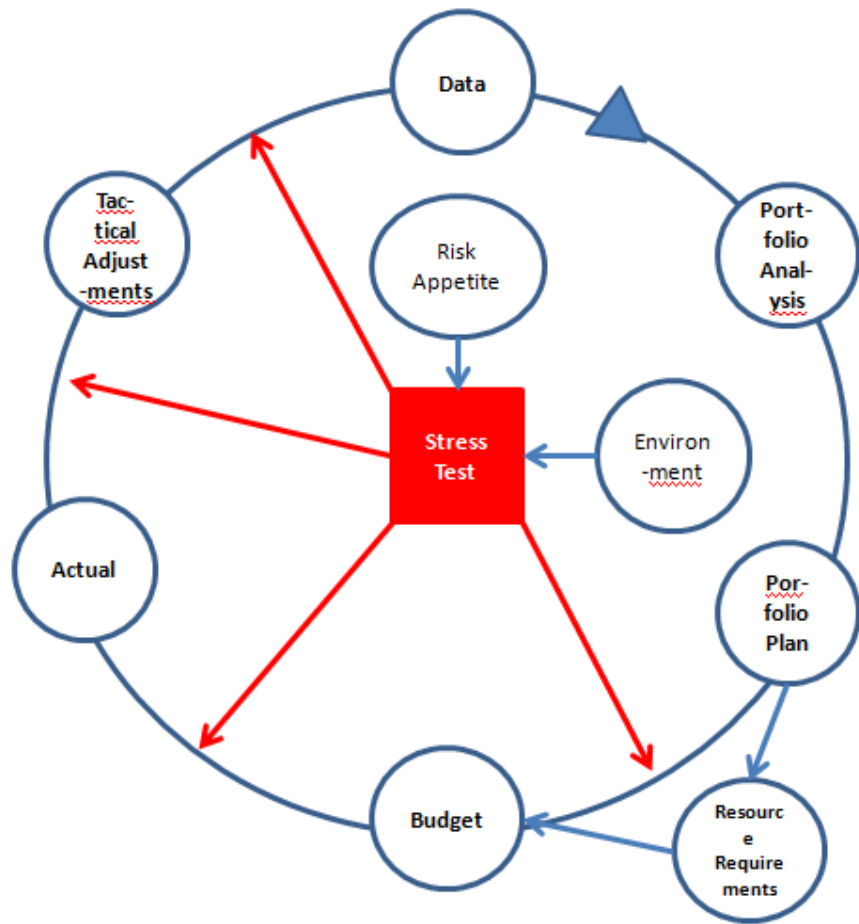
structuring the portfolio is the most effective way to do this, provided that the institution looks at the portfolio in terms of the full range of information available about the risks and equally importantly how they are measured, accounted for and taken

- Strategic portfolio management can, organizationally, be put in a number of places in a financial institution, provided that it is right at the top. The risk management team must accordingly have broad financial market experience, and a wide mandate, and be at the center of corporate planning and development, since it focuses on risk as the central activity of financial institutions. Risk management does have to “gatekeep” in the traditional manner, but if we talking “risk and return” obviously the function is broader. . Every part and policy of the institution must be shaped to support the risk portfolio and risk managers have to take a very broad view of how the institution works in order to effect this. The box on [the] _____ Bank’s system illustrates a good approach. Strategic Portfolio Management (centered in the “ X Group” reflecting that credit is the major risk in this “classic” deposit based institution, is part of the risk management group, reporting to a Vice Chairman and interacting with the CEO, but it is only part of the overall risk management function since it does not approve actual transactions, but rather evaluates the overall portfolio and carries out a number of business functions, such as creating credit scorecards, that keeps it close to actual business flows. It of course does some “gate keeping” but others also have responsibilities in this aspect of management in addition to the line business groups. The system might be termed “involved independence” or “independent involvement.

Conclusion

To make a financial institution work well, the leadership must ensure that its staff as well as its clients, regulators and other publics know what it is trying to do and why. With a strong strategic portfolio concept, I believe, this can be much better explained than if the institution sees itself merely as an earning machine. The clients are, after all, “the portfolio,” and it is client service for which banks and other regulated financial institutions are established. This will be the basis for “taking risks with a public purpose” which is actually the basis for banks, insurers and others who are granted charters. At the same time, such clarity will support the development of high quality earnings from a well-managed portfolio which will be rewarded by attractive multiples as a much sounder objective than mere generation of mark-to-market accruals to pay large bonuses.

The result of portfolio based thinking, as summarized in the following concept diagram, is that an institution’s budget and medium term plan is in fact a portfolio policy for which the revenue and cost dynamics are well known and can be converted into a budget. This plan is run through a series of stress test so that in the end the budgets and plans define the institution’s objectives under expected stress conditions but with the important consideration that even under far greater and not expected stress conditions in adversely dynamic markets, , the institution will maintain its liquidity and capital strength..



Basel and Portfolio Management

The Basel Committee, in its Principles of Credit Risk Management (12) stated: Banks must have in place a system for monitoring the overall composition and quality of the credit portfolio." Principle 13 reminded them to do this in a future-oriented way. The details of the Principles document focus on credit-related risks as opposed to the broader approach of this paper. The potential for saving capital through diversification is quite modest in the actual Accord, perhaps in part due to difficulty of measuring correlations quantitatively, in part because the Committee did not want to compromise its original eight percent target and technical reasons to facilitate handling of other issues.

The current, useful emphasis on stress testing is actually a way to back into portfolio management since the stress tests require that an institution's portfolio, as it may evolve, be tested against adverse conditions with a view to maintaining adequate post-crisis capital. There are elements here of "the tail wagging the dog." Stress testing can and should be regarded as a key component of budgeting and planning in a "risk first" world.

A more recent circular, "Principles for effective risk data aggregation and risk reporting," covers the way Portfolio Management has to be effected although with perhaps not enough emphasis that ALL institutional information is in fact "risk information" if used effectively. Note the emphasis on "aggregation" -- actual "risk data" are defined elsewhere. The Committee dealt with Government and Infrastructure, Risk Data Aggregation Capabilities, Risk Reporting Practices and Supervisory Issues. As could be imagined, the Principles call for accuracy, timeliness, completeness and integrity. An important aspect is "adaptability," Principle 6, which emphasizes need to re-cut and project data at short notice, although ability promptly to re-cut data even when not required by a crisis, is integral to the kind of management process discussed in the paper. All of this in turn reflects the need for data gathering at the lowest possible levels so it is aggregated and not calculated.

Principles 7-9 deal with accuracy, comprehensiveness and clarity and usefulness. These criteria of course cannot be denied. The point is that the CEO and other seniors should be involved in building the data base and laying out its aggregation algorithms so that they really understand what is at issue.

Information management, in a "risk first" environment, is not just technical people working out systems but managers saying, "What do we need and how should it be presented for our use?"