Fostering opacity

'Too-big-to-fail' is not just a moral hazard problem, it positively fosters dangerous opacity, argues ***David Rowe***

In a past career, when I had difficulty finding simple information such as staff locations, I was fond of saying: "We are so secure, even we don't know what we're doing!" Little did I think I might eventually find more truth than humour in this quip.

For at least the past 10 years, regulators have worked under the assumption that risk management in large global financial institutions was more effective than in smaller competitors. The implicit argument was that, with greater critical mass, large institutions could attract the best minds and mount more sophisticated risk assessments. As I have noted previously,[1] this view ignores the 'managerial diseconomies of scale' that accompany growing geographic and organisational complexity. In part, this is because the judgment so crucial to financial risk management becomes harder to maintain as the chain of command lengthens and top executives lose touch with many parts of the business.

Even in terms of the core information systems that are essential to enterprise risk management, however, the 'bigger is better' hypothesis fails miserably. The unrestrained growth in product volume and complexity over the past 10 years has overwhelmed the risk management infrastructure of global commercial and investment banks. Virtually no global institution with which I am familiar has the ability to assemble exhaustive trade-level detail on a daily (or any) basis. The lack of such a centralised repository makes effective simulation and scenario-based stress testing impossible.

At one level, this reflects the very significant cost required to establish and maintain such a system. It also reflects the often bitter political battles that rage among the risk management, trading and technology organisations over budgets and control. This is reinforced by the frequent lack of any senior executive with both the knowledge and authority to drive sensible compromises among issues of cost, accuracy (including the degree of analytical sophistication) and timeliness.[2] Arguably, however, there is a more insidious and corrosive force at work.

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Vincent Reinhart of the American Enterprise Institute has recently argued being too-big-to-fail provides a significant incentive to avoid effective data consolidation.[3] His argument is that complexity and opacity reinforce fears of the damage an institution's failure would inflict. For example, not knowing the precise extent of current counterparty credit exposure (let alone potential future exposure) stokes the fear that one institution's failure would inflict fatal damage on others, creating a systemic chain reaction. I have always felt this argument was overblown, but I must admit I would find it harder to sustain the position if the future of the financial system was in my hands.

Reinhart argues complexity and opacity create greater assurance among both management and investors that state support will be forthcoming. The result is an artificially lower cost of funds, which creates opportunities for still further growth. Such growth is accompanied by consciously more complicated balance sheets and more complex instruments that reinforce opacity. The value of opacity also creates significant incentives for foot-dragging on industry initiatives to reduce risk, to make closure easier and to increase efficiency and transparency. An excellent example of the last of these is the industry's notably lukewarm embrace of XML protocols such as Financial Products Mark-up Language over the past decade.

I am sure the irony of this is hard to miss. As Reinhart emphasises, making instruments more complex and balance sheets more opaque reinforces the benefits of regulatory arbitrage and the advantages of being too-big-to-fail. In addition, however, it undermines management's ability to monitor and control the institution they have created. This makes the financial system more vulnerable and less resilient, reinforces concerns about systemic feedback and serves to justify policymakers' conviction of the need for bailouts.

It appears I need to revise the quip I included at the beginning of this column. Perhaps the updated version should be: "We obscure our risks from the government so effectively that even we don't know what we're doing." ■

[1] *See Rowe, D,* Systemic Risk Capital, *Risk March 2009, page 73. (www.risk.net/public/showPage.html?page=844138)*
[2] *See Rowe, D,* Risk Information – Balancing Priorities, *Risk December 2004, page 68. (www.risk.net/public/showPage.html?page=199662)*
[3] *See Reinhart, Vincent,* Responding to the Financial Crisis: Lessons Learned, *May 2009, a presentation available at: http://www.aei.org/docLib/Responding%20to%20the%20Financial%20Crises%20-%20Remarks%20at%20Federal%20Reserve%20Bank%20of%20Chicago.pdf*