Unwilling or unable?

Regulators recently published the findings of a study of counterparty risk data at the world's largest banks. It makes for depressing reading, says David Rowe, and is symptomatic of deeper problems plaguing the field of enterprise risk management

An achievement in which I take some pride was designing and managing the implementation of the first simulation-based counterparty exposure system at the old Bank of America in San Francisco. Last December was the 20th anniversary of its launch in the bank's London trading room.

While this first implementation was on a regional basis, it later became global, supported by a worldwide trade data warehouse and a simulation system allowing global exposure profiles to be calculated on a daily basis. In 1996, these became the official metrics against which counterparty exposure limits were set and monitored.

At the time, I expected this kind of approach to take off rapidly elsewhere, but while it is now recognised as best practice, even some of the largest banks apply it in a patchy, haphazard way. Having had such high hopes – for so long – the *Progress report on counterparty data*, published on January 15 by the Senior Supervisors Group (SSG), makes especially depressing reading.[1]

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The report states: "Many firms discovered during the financial crisis that they could not aggregate counterparty exposure quickly and confidently…". This strikes me as overly polite. If bank senior management only discovered this inability at the time of the crisis, they were grossly derelict in their fiduciary duties. Certainly those at the top of any big bank's risk management function had to know how dysfunctional their counterparty information systems were. The simple truth is that senior management did not want to spend the money needed for a fix.

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Even today, in the aftermath of massive losses, with public confidence in banks' ability to manage risk at an all-time low and in the face of intense investor and regulatory pressure, the report says, "…progress has been uneven and remains, on the whole, unsatisfactory". Those familiar with regulator-speak will recognise that as a brutal put-down.

As if to rub it in, the report points out that in August 2008, just weeks before the crisis reached its nadir, the private-sector Counterparty Risk Management Policy Group III (or CRMPG III) stated in a report that "industry leaders expect firms to be able to monitor firm-wide counterparty risk exposures to institutional counterparties within hours".[2] That now appears to have been little more than wishful thinking.

In fact, the reporting demands placed by the SSG on 19 of the largest global banks were modest relative to the goal set by the CRMPG III report. In 2008, they were asked for daily reporting of data on exposures to their 20 largest counterparties, with up to a 48-hour lag from the underlying trade dates – a T+2 basis. In April 2011, the SSG exercise relaxed its benchmark for frequency and timeliness to weekly reporting on a T+3 basis or better "with the expectation that firms would maintain the ability to report data daily in a stressed environment". In exchange for the reduction in reporting frequency, regulators "expected firms to perform more robust data quality assurance (DQA) … with the goal of improving data quality".

Despite this forbearance on the frequency of reporting, the SSG found that, "In 2012, 14 of the 19 firms (74%) reported challenges in conducting adequate and timely DQA prior to report submission… common reasons cited include issues associated with data reconciliation across systems and confirmation of figures with subject matter experts across locations."

This last sentence captures the far deeper problem very nicely. While lack of will on the part of senior management is a contributing factor, the serious inability of currently deployed technology to support enterprise data consolidation represents a huge obstacle to enterprise-wide risk analysis. Counterparty credit risk across multiple trading locations and systems is only one of the most glaring manifestations of this more general shortcoming. But, as noted last month, until financial institutions move aggressively beyond the almost 30-year-old relational database paradigm, it would be foolish to expect much progress toward more effective enterprise-wide data integration and analysis (*Risk* February 2014, page 50, *www.risk.net/2325204*). **R**

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[1] *Senior Supervisors Group, Progress report on counterparty data, January 15, 2014: http://www.financialstabilityboard.org/publications/r_140116.htm*
[2] *CRMPG III, Containing systemic risk: the road to reform, August 6, 2008: http://www.crmpolicygroup.org/docs/CRMPG-III.pdf*