Perspectives on Dodd-Frank Act, Risk Management, and the Financial Crisis of 2008 from a Former Chief Risk Officer

Jeff Cohodes

Follow this and additional works at: https://lawecommons.luc.edu/luclj

Part of the Law Commons

Recommended Citation
Jeff Cohodes, Perspectives on Dodd-Frank Act, Risk Management, and the Financial Crisis of 2008 from a Former Chief Risk Officer, 50 Loy. Chi. L. J. 533 ().
Available at: https://lawecommons.luc.edu/luclj/vol50/iss3/6

This Speech is brought to you for free and open access by LAW eCommons. It has been accepted for inclusion in Loyola University Chicago Law Journal by an authorized editor of LAW eCommons. For more information, please contact law-library@luc.edu.
INTRODUCTION

Professor Ramirez asked me to share my thoughts, on a wide range of topics: (1) being the former chief risk officer of Northern Trust, (2) the 2008 financial crisis, (3) risk management in general and Dodd-Frank.

Managing risk is exceptionally difficult, and regulating it is even harder. In the wise words of Yogi Berra: “In theory, there is no difference between practice and theory, but in practice, there is.”

Expert judgement, behavioral research, and statistical analysis are all needed to be successful in managing risk and creating regulation. There is always strong debate around the role of risk management and regulation. Does theory work? Are financial institutions too complex? Are financial markets as well as financial instruments too complex? Who can predict the future? Will we be safe given our controls?

At the highest level of abstraction, regulation exists to both prevent the next financial crisis and systemic failures, as well as protect against an

*Former Chief Risk Officer at Northern Trust.
idiosyncratic bank failure in the future. At the same time, risk management’s three goals are to balance risk and return, avoid an idiosyncratic failure, and to survive a systemic failure. Remember, a bank takes risks in order to serve their clients and generate returns for their shareholders. It could be credit risk, operational risk, strategic risk, market risk or liquidity risk.

In layperson’s terms, fire prevention in the western states is a great example of a risk-avoiding regulation. The fire code requires specific building elements such as smoke detectors and fire extinguishers, as well as limits on campfires during dry seasons—looking to prevent both an idiosyncratic building fire as well as a systemic, widespread forest fire. Meanwhile, high-value homeowners, with strong incentives from the insurance companies, build in fire management solutions, such as ponds, in front of their houses, with the goal being to survive both a forest fire as well as to survive a fire starting in one’s own kitchen.

I. EIGHT ELEMENTS FOR EFFECTIVE RISK MANAGEMENT

As the CRO of Northern Trust from 2011–2017, my goal was to evolve our risk management framework and to protect the bank from a systemic or idiosyncratic failure. But my ultimate goal was to act in a way that would enable me to sleep at night. There were eight elements to the framework I used, which allowed me to achieve all three of those goals.

1. Know your risk takers—In 2011, I had been at Northern Trust for eighteen years as a risk taker. So, I knew all the material risk takers in the company, having worked with them in some capacity in previous roles. A bank inherently takes risks to serve its clients and generate returns for its shareholders, but those risks must be made mindfully.

2. Build a Superior Risk Team—Create an excellent and growing team of risk management professionals, comprised of people from the business (former risk takers) and risk management professionals.

3. Risk Framework—Develop a strong set of policies and procedures that define the enterprise risk management framework. This framework should in part be driven by Dodd-Frank.

4. Four-Dimensional Governance—Use a governance framework that looks at the company’s risks across four major categories: geography, risk type, legal entity, and business unit. This framework should factor in Dodd-Frank and foreign regulations.

5. Improve Capital and Liquidity Levels—Dodd-Frank and other regulations took these buffers to a whole new level. There is a benefit tradeoff between society and shareholders with this dynamic.

6. Direct Access to the Board of Directors—To be effective, the chief risk officer requires unrestricted access to the board. Topics can range
from individuals, to businesses, to risk management resources.

7. Cultural Risk Appetite—Financial institutions exist along a spectrum of risk appetite—from those where risk taking is encouraged through an incentive compensation structure, to those where customer retention is more highly valued. As any chief risk officer knows, swimming against a strong “cultural” current is difficult. There are two broad categories of risk: there are risks you take, such as credit or operational risks, and there are other risks that happen to you, like cyber risk. Unfortunately, some banks take compliance risk, which can lead to dire repercussions for both the bank and various aspects of the economy.

8. Positive Relationship with the Fed—As chief risk officer of Northern Trust, I experienced a very constructive and yet often frustrating relationship with the Fed. I often compared the Fed regulators, enforcing Dodd-Frank, to a personal trainer. You may not like doing the crunches and pushups that the trainer demands, but in the end, it is beneficial for you.

II. HOW TO BE A RISK MANAGER, AND ALSO SLEEP AT NIGHT

In my quest to sleep at night, I made sure that, during my waking hours, I was focused on the following complexities inherent in banking—including:

1. Human Misbehavior—Examples include The London Whale, money laundering, foreign exchange manipulation, LIBOR manipulation, and compliance violations ranging from auto to mortgage lending.

2. Boom/Bust Cycles—As the old banker adage goes, the worst of loans are made in the best of times.

3. Risk/Return Trade Offs—Can you quantify the risk? And what’s the probability of return?

4. Lobbying—As you have read in the newspapers, it’s currently impacting the Dodd-Frank regulations.

5. Financial Innovation—Are derivatives weapons of mass destruction?

Much has been researched and written about the crisis and the dynamics at play. But to me, one perspective from the sport of mountain climbing rings true. “Jill Fredston is a nationally recognized avalanche expert . . . She knows about a kind of moral hazard risk, where better safety gear can entice climbers to take more risk—making them in fact less safe.”

III. THE FINANCIAL CRISIS

Ten years ago, ten factors created a perfect storm that led to outsized financial risk, and ultimately the financial crisis. 4

1. Credit bubble
2. Housing bubble
3. Nontraditional mortgages/securitization
4. Credit rating agencies
5. Financial institution concentrated correlated risk
6. Leverage and liquidity
7. Risk contagion
8. Common housing shock
9. Financial shock and panic
10. Financial crisis leading to economic crises

According to the US Government Financial Crisis inquiry report of 2011: 5 financial crisis was avoidable; widespread failure in financial regulation and supervision proved devastating to the stability of the nation’s financial markets; and dramatic failure of corporate governance and risk management occurred at many systemically important financial institutions. Excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with the crisis. Additionally, the government was ill-prepared for the crisis, and its inconsistent response added uncertainty and panic. But overall, there was a systemic breakdown in accountability and ethics that led to the crisis.

As is well known, the Dodd-Frank Act followed the crisis and addressed many topics including:

1. Capital
2. Liquidity
3. Leverage
4. Annual stress testing
5. Derivative reform
6. Credit rating agencies
7. Consumer financial protection
8. Volcker rule
9. Executive pay disclosure
10. Resolution authority
11. Living wills
12. Deposit concentration limits

---


5. See generally id.
13. Elimination of FDIC guarantee authority
14. Elimination of Fed power to lend to nonbanks

As we think about Dodd-Frank, we should ask ourselves whether increased regulation that drives intense regulatory supervision can reduce the risks in banks, many of which are systemically important financial institutions. Dodd-Frank empowered regulators with rules and data to proactively assess a bank’s decisions on strategy, operating model, risk appetite, governance, and risk culture.

However, culture is a difficult animal to regulate. It is what results in either prudent or excessive risk taking. It is what permits or discourages risk taking, beyond corporate appetite or for personal enrichment. A strong risk culture results in recognizing risk issues, assessing risk, escalating issues, and timely remediation. It drives accountability, tone from the top, open challenge, compensation paradigms, teamwork, and succession.

IV. HOW EFFECTIVE IS DODD-FRANK?

As we are in an academic setting, this section will give a test to Dodd-Frank and grade it on an A–F scale:

Did Dodd-Frank strengthen the regulator and supervisory framework to create safeguards to prevent future unknown crises and avoid taxpayer funded bailouts of some banks?
[Grade A]
Did Dodd-Frank strengthen risk management and governance around capital, liquidity, and risk appetite?
[Grade A]
Did Dodd-Frank effectively address shadow banking, repossessions, derivatives, off-balance-sheet entities, credit agencies, securitization, and mortgage lending?
[on average, Grade B]
Did Dodd-Frank materially improve the regulators’ understanding of the financial system, its interconnectivity, and exposure management?
[Grade A]
Did Dodd-Frank change tone from the top and bank executive accountability?
[Time will tell]

Although Dodd-Frank has a strong report card from me, it is important for us to remember the famed investor, Howard Marks’s statement:

Risk exists only in the future, and it’s impossible to know for sure what the future holds. . . . No ambiguity is evident when we view the past. . . . Many things could have happened in each case in the past, and the fact that only one did happen, understates the variability that existed.
Projections tend to cluster around historic norms and call for only small changes. . . . The point is, people usually expect the future to be like the past and under estimate the potential for change.

People overestimate their ability to gauge risk and understand mechanisms they’ve never before seen in operation.

CONCLUSION

I would now like to share some thoughts from a former chief risk officer:

At times, a one size fits all mentality across regulatory enforcement occurs, which is suboptimal for a bank and its shareholders. A balance must be struck between statistical models and expert judgement. Bank boards have potential to lose the forest for the trees due to regulatory compliance oversight. And the next generation of bankers and regulators will benefit from further enhancement of data. But what are the soft and hard costs to society and to bank shareholders due to Dodd-Frank? They are at times on the opposite side of the trade. The pendulum is currently swinging back. Where should it land?

In summary, for regulation to be effective, it must be paired with a strong risk management framework, consisting of:

1. Known risk takers
2. Strong risk team
3. Risk framework policies
4. Four-dimensional governance
5. Strong capital and liquidity
6. Access to board of directors
7. Prudent cultural risk appetite
8. Partnership with regulators

Hopefully this framework will be a beneficial approach to protect against the next financial crisis, whether it be due to US pension shortfalls, municipal debt levels, the Eurozone, or a cyber-attack that precipitates a crisis.