NEW RISKS FROM DODD-FRANK: THE FINANCIAL SERVICES INDUSTRY MUST REDUCE COMPLEXITY

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Globally, regulators are ramping up rules related to financial stability and systemic risk. A clear purpose will be to enhance capital adequacy and management of known risks such as credit, market, operational and liquidity. Meanwhile, less predictable threats are on the horizon. The complexities of financial parties, products and instruments continue to increase, and the current wave of regulation may be ill prepared for the surge in financial intricacies. Unrestrained complexity will be a future source of instability.

Interdependencies between counterparties and products build and compound complexity exponentially. In addition to such explosive growth, firms must cope with the added breadth and depth of client relationships. As clients subscribe to diverse credit, investment and transaction products, firms must also constantly monitor the changing interplay between credit, collateral, foreign exchange and liquidity positions for each relationship. Firms must also factor the nuances of interrelated products across client segments (e.g., by size, location, and industry.).

Navigating the financial system: Will "Too big to fail" become "Water under the bridge"?

Firms and business operations may become "too complex to manage." In some cases, strained capital ratios or downturns in operating performance prompt corrective surgery. Boards of Directors as well as regulators then rush structural actions to dispose of risky assets, spin off non-core business units and divest potentially conflicting lines of business.

However, such dispersion may have the unintended consequence of increasing complexity risk. Extra points of liaison and control between the newly separate businesses will augment systemic complexity.

A common cause of shipwreck: Will external factors surface uncommon risks?

In a 2011 Economist Intelligence Unit survey conducted on behalf of SAS, 63 percent of the polled C-level executives indicated that "complexity is increasing the risk exposure for my organization." Concerns about complexity however, are being met with an "out-of-sight" mindset as most executives seem complacent with managing risk adequately within the confines of their firms.

In order to be effective, internal and external controls must be straightforward and applied within holistic operating workflows. In general, breaking up seemingly independent functions should improve the ability to manage them individually. Structural asymmetry, coupled with new modes of interaction between separate business functions, may give rise to unexpected fractures and imbalances.

Financial asymmetries may involve unwanted concentrations in long or short positions, excesses or shortfalls in liquidity and concentration of risk. Financial firms and regulators must manage the ebb and flow of such asymmetries and bring them back to balance. Governance mechanisms should mind new business dynamics effectively and adapt quickly to unexpected situations. Overwhelmingly, financial executives point at the need to improve relationships between risk management and business functions.

Sinking in fears and tears: Impact and effectiveness of macro prudential regulations

Given the reactive nature of financial regulations and protracted wrangling with affected firms, the implementation cycle continues to lag market changes. Eighteen months after passage of the Dodd-Frank Act, financial firms and regulators are still debating the tone and deadlines of key rules. Delayed action may result in ineffectual rules that are aimed at mitigating past symptoms while overlooking emerging threats. A narrow focus on solving points of severe distress or imbalance may lead to distorted or dysfunctional effects. For example, in a heavily interconnected financial system liquidity may evaporate instantly. So instead of fulfilling a balancing role of providing much needed liquidity during sudden market distress, speculative short-selling could undermine systemic health.

There has been widespread consensus about the imperative to improve prudential standards and reduce systemic risk. Opposite such sensible understanding, some nonbank financial firms and large bank holding companies have been calling for a delayed or paced implementation of mandatory resolution plans and credit exposure reports. These rules stem from section 165 (d) of the Dodd-Frank Act. They require affected firms to articulate a plan for rapid and orderly resolution in the event of material financial distress or failure. Among other sound management provisions, resolution plans must adequately protect firms from risks arising from the activities of any nonbank subsidiaries. Plans must also identify cross-guarantees tied to different securities and the major counterparties, and set out a process for determining to whom such entwined collateral is pledged.

Firms must stay abreast of ongoing changes in the dynamics and structure of financial markets. Some regulations hint at complexity risks. A recently proposed regulatory guidance on stress testing for banking organizations with more than USD 10 billion in total consolidated assets, states that "A banking organization should carefully consider the incremental and cumulative effects of stress conditions, particularly with respect to potential interactions among exposures, activities and risks and possible second-order or 'knock-on' effects." Section 165 (i) of the Dodd-Frank Act calls for more comprehensive stress tests to be carried out at least annually. At a minimum, systemically important firms and certain nonbank financial companies are being asked to conduct semiannual stress tests.

Financial firms have been making significant progress in managing and measuring operational risks, including advanced approaches to calculate adequate capital reserves. Notwithstanding such internally focused progress, the unchecked complexities of external interactions along the financial value chain will build up considerable and potentially crippling operational risk.

Beyond functional and enterprise risk: Who is afraid of complexity risk?

Besides improving the regulatory framework, the financial sector should understand the perils of undeterred complexity risk. Moral principles, economic purposes and professional ethics should inspire more pragmatic accountability and transformative actions. Firms should take a fresh look at the evolving business flows and reformulate their operating principles to fulfill a primary financial enablement role in a profitable albeit systemically responsible manner. Thoughtful analysis of the value added by each business function, control, and client offering will prompt firms to streamline convoluted or risky schemes. Embedding sound risk management principles within diverse business functions will help in anticipating and acting upon emerging changes.

