Lead Left Interview – Adrian Docherty

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This week we chat with Adrian Docherty, who heads up BNP Paribas' Bank Advisory team. His team helps banks who are customers and counterparties of BNP Paribas to improve their management of risk, capital, funding, liquidity and profitability. He is also the author of *Better Banking: Understanding and Addressing the Failures in Risk Management, Governance and Regulation*.

The Lead Left: Adrian, your clients are major global banks. What are the challenges they face today?

Adrian Docherty: Now that Basel III is live, we have a drive for effectiveness, simplicity and harmonization, but different initiatives are taking us in different directions, which results in increased complexity and contradictions. Some of what the banking authorities say in theory doesn't follow through in practice. The ECB and other agencies make pronouncements that make sense on the surface, but you can over-interpret them. And the messages don't tally with the actual data.

TLL: Could you give our readers some examples?

AD: IFRS 9 [International Financial Reporting Standard], and CECL [Current Expected Credit Loss] which is the FASB version, are good examples. These deal with provisioning in a bank's balance sheet.

The G20 looked into causes of the Global Financial Crisis, or the Great Recession as you call it in the US. Provisions were taken too little, too late. The solution was to look forward and build up reserves to cover future losses and to increase those reserves as loans are downgraded. But a set of accounts is meant to represent the financial position today, a "fair" values. With a forward-looking model, you need a risk view and, quite frankly, financial accounts are not meant to be where risk is incorporated. A risk view requires predictions and assessed probabilities of events happening in the future. Under the new accounting standards, auditors will need to use complex risk models to model expected loss. It's a whole new way of accounting and it's a lot more complex.

TLL: What are the hot buttons that your clients are focused on?

AD: In Northern Europe, for example, it's the introduction of floors on risk-weighted assets. In the Netherlands, for example, there's a robust mortgage and corporate lending market that's definitely a low risk activity. Because the Basel initiatives say you can't rely on banks risk measures, you need measures that are uniform. That means standardized risk and floors.

Equating risk across the globe is to the detriment of lower risk markets. Loans that – rightly – don't consume much capital now will be forced to double or triple capital to meet solvency requirements. That may constrain those low-risk lending activities. The lender may have to reprice or get out of that business.

TLL: But how do you get regulators to trust banks to be honest about their own problem loans?

AD: Mistrust of internal banks' risk weights has been around for a while, despite increasingly sophisticated risk management techniques over the last decade. It's a real shame and regressive. I'm a big fan of the use of internal models for risk management and regulation. If regulation is not risk-sensitive, low risk business will be neglected and this will result in unintended consequences as banks are incentivized to take on more risk.

TLL: Why are the lowest risk loans the target, when surely they didn't cause the credit crisis?

AD: Well, maybe we didn't learn from the subprime debacle, which after all was perceived by many to be a low-risk, "triple A" market. Today, in large, leveraged and seemingly low risk markets, the authorities are worried about the systematic risk of concentration. By that logic, would I prefer to have risk held close to home in the banks or distributed widely? Personally, I think pushing these risks outside the banks make them less visible and less controllable. We're forcing certain types of risk outside of regulatory bounds. For example, peer-to-peer lending is attracting competition, but we're ceding some control to potentially unreliable actors who haven't been tested. The unintended consequences are the creation of a new monster of a financial system that brings new, unintended risks.

TLL: What's the timing on implementation on Basel III? It seems like it's taking forever.

AD: There's actually no such thing as I, II, III, or IV. The numbers are fictitious. Journalists like to use nicknames for milestones. In fact, the 2009-10 Basel milestone was not given a name by the Basel Committee, but when the label "Basel III" became ubiquitous, then the authorities caved and said, Ok, it's Basel III. Anyhow, regulation is an on-going process. Personally, I resisted the label "Basel III" since the new rules weren't too much different from Basel II. All that was new was the higher capital requirements and the tighter definitions of hybrid capital instruments. Hardly a new concept. Perhaps the label "Basel 2.1" might have been more appropriate?

The evolution of regulation post-2009 has really been a piecemeal process. One frustration in the capital markets is, as one regulation gets understood, another one comes along. How can shareholders and bond investors predict the effects? Regulation will be driving capital markets activities for a while to come.

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