Closing Comments

Governance of Non-Financial Risk in an Age of Global Discord

by PAUL TUCKER

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Recent failures in banking highlight the continuing fault lines, to put it lightly, in the governance of financial institutions, and among their regulatory and other overseers. Quite apart from the immediate issues, this raises the prospect that business is ill-equipped to navigate the extraordinary geopolitical fractures they are likely to face over the coming years and decades.

Starting with the recent humdrum failures, the most striking thing is the extraordinary passivity of those involved until the tragically familiar illiquidity vortex engulfed them. In the case of Silicon Valley Bank, directors and supervisors seem to have been frozen in the face of growing latent losses from plain vanilla interest-rate exposures, and over reliance on short-term funding from uninsured depositors. As an outsider, one cannot know, but in their effects they put on a good impersonation of not understanding the basics of banking and its timeless fragilities. In the case of Credit Suisse, a much more complex outfit, liquidity tremors during autumn last year were not enough to prompt action to rein in their mismatches and de-lever their book, including in wealth management, and to ensure there was enough free collateral to cover an all-out run in a number of international currencies.

On the official side, meanwhile, in the US the authorities had formally chosen to cease planning for the failure of large regional banks even though they must have known that they did not have a good plan.[1] In Switzerland, the authorities abandoned a plan discussed with international peers for years, for reasons that the various public statements have barely begun adequately to explain. Funny old world.

But if the governance and oversight of relatively straightforward financial risks is so slack, how much can realistically be expected for often-more-complex non-financial risks, we might reasonably ask? The hazard is compounded by three things, two relatively minor in the great scheme of things, one massive.

The first is the most general. Given how very basic (and so, historically, well understood) SVB's vulnerabilities were, it suggests the executive faced little challenge at the board, or that any meaningful challenge was swept aside or deflected. If, contrary to my assumption, no one on the board did understand the now obvious vulnerabilities, there is the question of whether board members had pressed for a risk oversight process that would flush out the risks behind strong headline returns. And, if not, there is the still more-basic question of whether the board had a tolerably decent process for identifying and filling gaps in its own expertise. Hence, operational risks can run through a board itself. Shareholders, and their agents, with check lists and so on, might not get that.

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Those questions matter well beyond basic financial risk because non-financial risks come in all sorts of shapes and sizes. The only way to identify such risks, on the upside as well as the downside, is to combine imaginative horizon scanning with a relentless (but constructive) process. And the only way to address them, once identified, is with tight policy responses and disciplined execution subject to penetrating oversight, and a willingness to update the board's thinking in the light of events.

The second issue is whether non-financial risk has descended, via a culture of compliance with voluminous rules, into merely a cost of doing business. This, crudely, amounts to: read rule, interpret it in a way favourable to the business, monitor compliance, accept there will be violations, pay fines, carry on.

One problem, among many, with this culture is that it heavily discounts the likelihood and severity of reputational risk. One journalist aptly described the giant Swiss bank as having "managed to scandalise itself out of existence."[2]

When reputational risk crystallises in a big way, customers can flee the business in a manner not dissimilar to a financial run. Sometimes, no one wants to be seen dealing with a firm after disgrace precisely because others are walking away. That was a lesson for accountancy firms from Enron and its ilk. It surfaced again recently with a UK business trade association.[3] Such business "runs" can, today, be triggered by whatever catches the moral spirit of the times. Like a bank run, no one sees it coming until it's too late.

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That might one day include sanctions violations, which brings me to the biggest and most imponderable set of non-financial risks that businesses need to grapple with. The geopolitical tensions between the world's two superpowers are significant for business because, in contrast to the old Cold War, China and the U.S. are commercially and economically entangled through global supply chains and mobile capital. Short of war, when businesses' loss of influence is starkest, executives and boards need to be psychologically prepared for economic decoupling on a much greater scale than now. That is one of the core themes of my recent book, *Global Discord*.[4] Nearly all of us in the rich world are too used to taking peaceful coexistence for granted: that the sea lanes will remain open, piracy kept in check, conscription a relic, planning for conflict a memory, and lots more. All that rested upon a complex accommodation among older superpowers, together with consensus among the free world's great economic powers. No longer.

Yet, while western politicians have been waking up (at the risk of overreacting) to geopolitical competition, the same cannot be said of business. Recently, the boss of a massive manufacturing company said that cutting trade with China was "unthinkable".[5] Unthinkable, remember, is very different from undesirable or unlikely. Although not highly likely, severe decoupling is not unthinkable. More precisely, cutting ties with China is unthinkable only if it *is* thinkable for the firm to cut ties with the US — even with Europe. Maybe that's what the CEO meant to convey, but I doubt it as that would signal a readiness to move the group's domicile out of Germany, a country that, like the rest of Europe, relies on the US security umbrella.

Alternatively, saying that exiting China is unthinkable might signify little more than that the company has not thought about it very much. That too would be worrying because bosses — in both the private and public sectors — tend to cope better with unexpected disasters if they have internalized the possibility of severe bad outcomes, and thought carefully and realistically about the tough choices they might confront — or, let it be said, have imposed upon them. After all, before the US entered World War I, there was only one (transatlantic) group called Merck. Since then, there have been two, because its US and German arms were separated, never to be re-joined. The point here is not prediction but, rather, realistic horizon scanning.

What to do about this is an important and immensely difficult question. To a significant degree, it has to be about incentives. Take cyber security. While businesses care about guarding against cyber theft that damages their franchise, they don't have strong incentives to protect against cyber infiltrations/attacks that could compromise national security. For that, we might need statuary minimum standards, with rigorous enforcement where it truly matters.

But that kind of rules-based prescription and proscription is hardly suitable for other manifestations of geopolitical and geoeconomic risk. There probably needs to be some kind of dialogue about how groups should organise themselves to cope with a shift to self-contained economic blocs. But that, somehow, has to be done without making more likely the dramatic contingencies being prepared for. It might be a matter of the official sector providing guidance on how to think about the risks to those business leaders who are not remotely themselves a security risk. Financial firms can probably do a good deal of that themselves, although we should not expect to see it in the shop window.

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Summing up, as *Global Discord* argues, our geopolitical predicament means the West cannot afford another financial crisis. More than that, we cannot afford any kind of home-grown crisis that jeopardizes order, security or local legitimacy. That raises the stakes for the management of private operational risk, and hence for governance, in ways that, for understandable reasons, the private sector has hardly begun to internalise. That is the most weighty conclusion to be drawn from recent banking failures.

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ENDNOTES

1 https://www.systemicriskcouncil.org/2019/07/systemic-risk-council-urges-federal-reserve-and-fdic-not-to-relax-resolution-planning-requirements-for-large-us-regional-banks/ LINK

2 https://www.ft.com/content/ee75dc94-2919-42c6-b40d-0e2ee556af83 LINK

3 https://www.ft.com/content/d2952a9e-a1f0-42af-aad2-eea8ccf09769 LINK

4 https://press.princeton.edu/books/hardcover/9780691229317/global-discord LINK

5 https://www.ft.com/content/ddf0b2fc-635f-425e-8735-36abf6fdc796 LINK