Minutes of the October 17, 2014 Financial Advisory Roundtable (FAR) Meeting

Present: FAR Members: Terry Belton, Markus Brunnermeier, Darrell Duffie, John Geanakoplos, Darryll Hendricks, Andrew Kuritzkes, Andrew Lo, Deborah Lucas, Stephen Ryan, Tano Santos, David Scharfstein, Antoinette Schoar.
FRBNY: Tobias Adrian, Christine Cumming, Sarah Dahlgren, William Dudley, Joyce Hansen, Beverly Hirtle, Antoine Martin, Jamie McAndrews, Alberto Musalem, Sandra Krieger, Simon Potter.

Two topics were covered in the meeting. The first topic was on the private safe asset creation and financial stability. The second topic was on the role of governance and culture in risk management. The meeting included two presentations, one for each topic, from roundtable members centered on the questions posed in the meeting agenda (http://www.newyorkfed.org/aboutthefed/far.html). Each set of remarks was followed by an open discussion among FAR members.

The main topics were as follows:

Topic 1: Private Safe Assets Creation and Financial Stability

How do we define safe assets? FAR members first discussed the characteristics of safe assets, including store of value, collateral for transaction, and source of liquidity. Members had differing opinions as to what constitutes a safe asset. The majority of members viewed safety of assets as multi-dimensional and a relative term; some FAR members argued that it was misleading to describe a dichotomy between safe and risky assets, as assets exist along a continuum of risk/safety. The notion of safety could change over time, across different markets and investors, and is self-fulfilling depending on investors' perception. Some FAR members highlighted the importance of distinguishing the "money functionality," or the way these assets can perform transaction services. In this view, safe assets are "money-like."

What are the determinants for the demand and supply of safe assets? The introductory presentation mentioned that safe assets, as a share of total assets, have stayed stable since 1952, while the asset to GDP ratio has increased by a factor of 2.5. The composition of various safe assets, however, has changed tremendously, as the shadow banking sector has become the main supplier of (private) safe debt. FAR members then discussed what has caused these changes. Some members argued that increased demand led to a shortage of safe assets and an increase in the supply of private safe assets. They suggested that global imbalances boosted the demand for safe assets, as sovereign funds sought an investment outlet in the form of information-insensitive assets. Others disagreed with this demand-driven view, and asked whether there actually has been a "shortage" of safe assets, highlighting a lack of measurement. Some members argued that recent regulatory changes (e.g., leverage ratio requirements, money market fund reforms, liquidity regulations) could affect the stock of safe assets, and expressed concerns that the increased requirements to hold high-quality assets will generate pressure to create such assets. Some members expressed concern that the requirement to hold high-quality assets could lead to excessive creation of privately engineered "less safe" assets that incorporate certain tail risks.

What are the potential risks to the financial system and what should be done to mitigate them? FAR members agreed that private safe assets are not perfectly safe and that tail risks could still remain in the creation of such assets. Such tail risks, if they are neglected, could pose a serious threat to systemic stability in case they were to materialize. In such a scenario, the supply of aggregate safe assets in the system could collapse, leading to a fire sale liquidation of the once perceived safe assets and a subsequent shortage of safe assets as flight-to-quality arises. Another potential risk is a build-up of excessive leverage by financial institutions using private safe assets. FAR members discussed various measures to contain the potential risks, as well as how to measure these risks. They agreed that it would be useful to keep track of the valuations of these assets, the demand for such assets, as well as the regulatory requirements for holding those assets.

Topic 2: Role of Governance and Culture in Risk Management

What is culture and does it matter? The introductory presentation highlighted that there are many ways one can define culture, but the common element is **shared** values and behavior in a community. These shared values are taught as the "right" or the "correct" way to new members of that community. Some FAR members referred to these shared behaviors as "routines" performed in the organization. Then a discussion ensued about whether bad outcomes are a result of routines or are caused by deviation from them.

FAR members agreed that culture matters for risk management. Members pointed out that culture is co-mingled with financial incentives, and it is easier to change the latter than changing the culture of a large organization. Members also discussed historical cases in which certain types of culture (e.g., excessive trust of creditors, overconfidence in risk management, and culture of neglect) led to critical failures in risk management. They agreed that culture matters even more in the financial industry than in other industries, as the risks evolve much faster in financial institutions, and the externalities from mismanaged risks are much larger.

How is culture in the financial industry different from that in other industries? FAR members attributed the unique culture in the financial industry to the output of the industry; a kind of selection bias in the recruiting process; and the incentive built into past and current compensation programs. First, unlike production industries where employees are responsible for the quality of material products, employees are evaluated mostly based on their contribution to the firm's profitability. Second, financial firms aim at recruiting the "best and brightest" junior staff as the current culture dictates, to project an impression of competence. Third, many compensation structures are tied to short-term relative performance of the employees, which induces excessive risk-taking behavior focusing on short-term profits and overlooks tail risks that are unlikely to materialize in the near future. Some FAR members noted that the culture of trading businesses should be differentiated from the culture of traditional commercial banking business, and that of the insurance industry, arguing that many problematic aspects of financial industry culture are most closely associated with trading businesses, rather than with commercial banking more broadly.

Can we change it? FAR members agreed that improving culture in a large organization is not an easy task. They proposed various ways to promote better culture and incentives. The majority of FAR members are proponents of deferred debt-like compensation for material risk takers, though at least one FAR member raised concerns that the impact of "claw backs" and deferred compensation is significantly muted for employees who leave a firm (the new employer can, in effect, "buy out" the deferred compensation). Some FAR members suggested improving accounting standards to enhance transparency of asset values and to help management internalize losses, if such occur, both of which would allow investors to better monitor and discipline the firm. Many FAR members agreed on the importance of the role of the risk management officer. Some suggested that the Chief Risk Officer (CRO) should report to the board, rather than to management, and that CRO compensation should be tied to a risk management target, such as volatility of income or revenue, rather than to the firm's profitability. Other FAR members proposed that there should be more visible penalties for firms' misbehavior. Other proposals from the members included better corporate governance by equity holders, an independent board with financial experts, and an enforcement of behavioral norms.