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Research: Hiring Chief Risk Officers Led Banks to Take on Even More Risk

by Kim Pernell, Jiwook Jung, and Frank Dobbin

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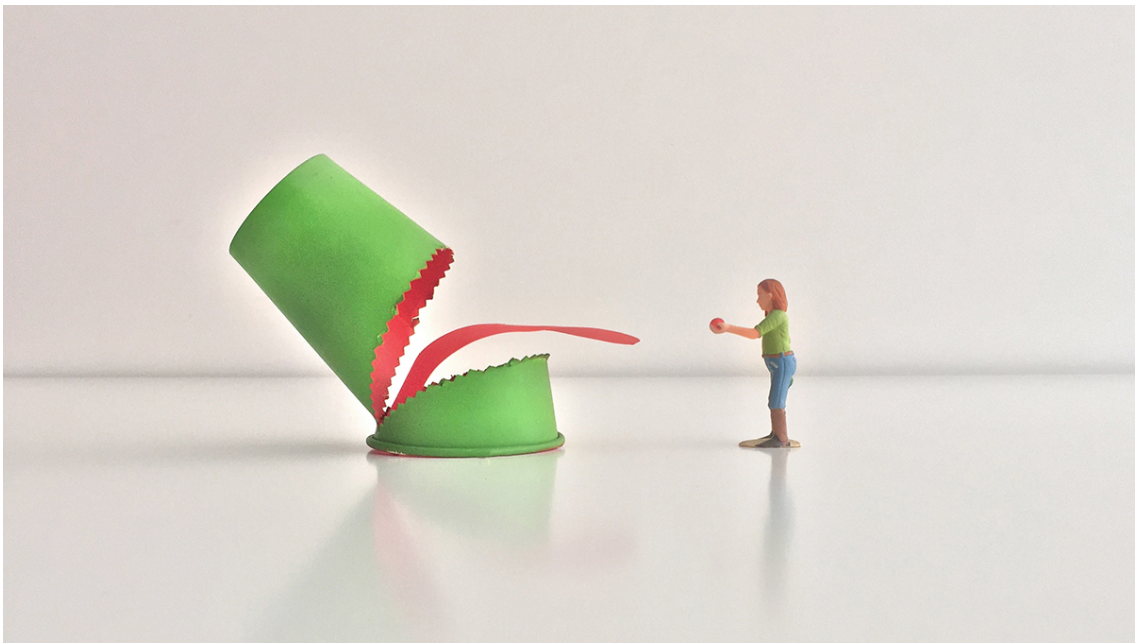

Paul Garbett for HBR

Summary. Risk taking by big U.S. banks exploded in the years leading up to the financial crisis, much of it coming in the form of complex and opaque financial instruments like derivatives. But why did banks get in so deep with derivatives, particularly after Washington tried to... **more**

Risk taking by big U.S. banks exploded in the years leading up to the 2008 financial crisis, with disastrous consequences for American firms, markets, and households. Much of the added risk, of course, came in the form of complex, opaque financial instruments like derivatives, the "financial weapons of mass destruction" that played such a central role in the crisis and the panic that followed.

But why did banks get in so deep with derivatives, particularly after Washington tried to crack down on risk with new laws and regulations in the early 2000s? In a recent study, published in the American Sociological Review, we trace the growth in bank risk taking to a surprising culprit: the rise of the chief risk officer (CRO). Many banks, it turns out, responded to new regulatory and reporting demands by appointing a CRO, as a way to show regulators and investors that they were serious about risk management. The popularity of this position skyrocketed after CROs (and the centralized enterprise-risk-management programs they oversaw) became the gold standard for compliance. In 2000 fewer than 1% of big banks had a CRO. By 2006 nearly one-quarter did.

We suggest that CROs did not reduce bank risk taking — in fact, they became part of the problem. We came to this conclusion after analyzing the CRO's effect on one particularly important form of bank risk taking: exposure to high-risk, high-return derivatives. After examining the derivatives activity of the 157 largest U.S. banks from 1995 to 2010, we found that banks with a CRO were substantially *more* likely to get in over their heads with the riskiest kinds of financial derivatives — over-the-counter options, swaps, or credit derivatives. Banks with a CRO were much more reliant on these newer, riskier derivatives — but not on older, more vanilla derivatives, like futures and forwards, which have traded in American financial markets for centuries.

On the surface, the fact that the presence of a CRO would actually increase a bank's exposure to risk may seem puzzling. But not if you look at the history of the risk management profession. Bank executives first turned to risk experts in the 1980s to help their

institutions survive the financial wreckage of the Latin American debt crisis, the commercial real estate crisis, and sky-high interest rates. But as these events faded from memory, risk experts found it harder to demonstrate their value to bank leaders. They tried to spice up their profession's stodgy image, downplaying their role in policing risk and emphasizing their ability to produce what shareholders wanted most: supercharged profits.

But in hitching themselves to the shareholder-value bandwagon, they had to abandon their old mantra of reducing risk, which wasn't seen as being in the interest of shareholders. Instead, they embraced a new mantra of "maximizing risk-adjusted returns," which involved using their expertise to bring risk right up to the edge of allowable limits, with no wasteful margin for error.

Enter derivatives. The newer, riskier derivatives were thought to help optimize risk by making it faster, easier, and cheaper to acquire or unwind exposures to particular investments, and by making new, customized risk transfers possible. By the time risk experts were elevated into new positions as CROs, they were already accustomed to seeing new derivatives as the right tools for the job.

But it wasn't just the actions of the CROs themselves that encouraged riskier behaviors. It's likely that their mere presence affected the decisions of other actors within banks as well. Psychologists find broad evidence for a "moral licensing" effect — for instance, when people are told that their employer guarantees equal opportunity, they become less likely to self-monitor for bias. A similar effect may help to explain the results here. In creating a new, high-level position to oversee risk management (signaling that the bank was "risk aware"), executives may have encouraged the managers of other bank departments to become less cautious in policing their own risky behavior.

CEOs and institutional investors also played a role. When they had more skin in the game — for example, if they held a lot of stock in the company — they restrained the CRO's push for risky derivatives. But

the opposite was true when CEOs received more compensation in the form of performance pay (like a big cash bonus), which rewards outsize risk taking but doesn't penalize losses. Banks with bonus-heavy CEOs were much more likely to abuse all kinds of derivatives, regardless of whether a CRO was present.

It's important to note that we didn't find evidence for a common assumption: that risk-hungry CEOs appoint CROs to "cover up" their plans to move into riskier activities. A CEO's risk appetite didn't predict the decision to appoint a CRO. Neither did a bank's prior derivatives activity nor a host of other factors known to predict movement into riskier domains of finance.

These findings hold an important lesson for corporate leaders who want to avoid repeating the risk-management debacles of the past: Even the most sophisticated risk-modeling techniques won't keep banks out of trouble if CROs believe that their duty to maximize returns trumps their duty to minimize catastrophe. True, shareholder-value proponents may argue that managers who err too far on the side of caution are not serving investors. Yet for systemically important institutions like banks, taking risk to the brink can bring more harm than good.

CROs have only become more popular in American banking since the credit crisis, boosted by a provision of the Dodd-Frank Act of 2010, which requires banks to adopt the kind of centralized risk-management programs that CROs specialize in. This trend is worrisome. While CROs have largely turned away from risky derivatives since the credit crisis, their broader agenda of maximizing risk-adjusted returns has not changed. If policy makers and corporate leaders continue to delegate oversight for risk management to actors who seek to "optimize risk," they shouldn't be surprised when financial disasters and scandals follow.

KP

Kim Pernell is an assistant professor of sociology at University of Toronto and Canada Research Chair in Economic Sociology.

JJ

Jiwook Jung is an assistant professor at the School of Labor and Employment Relations at the University of Illinois at Urbana-Champaign.

Frank Dobbin is a professor of sociology at Harvard University.