RMA Survey Reveals Growing Awareness of Wrong Way Risk

This article is drawn from the Executive Summary of the “Wrong Way Risk” survey undertaken by RMA’s Market Risk Council with the assistance of Deloitte.

The Risk Management Association recently surveyed financial institutions to determine the range of practices and standards they are currently or planning to use to manage wrong way risk. Wrong way risk (WWR) is defined as the risk that a bank’s credit exposure may be adversely correlated with the credit quality of its trading counterparties. Wrong way risk is not new, but it has been moved to the forefront of the risk management and regulatory agendas following high-profile defaults. According to the Basel Committee on Banking Supervision, which sets international capital standards for financial institutions, a failure to adequately accommodate wrong way risk was a key failure of existing counterparty risk capital frameworks.

The purpose of the RMA survey was to understand attitudes and capabilities across the industry for managing WWR, the nature and scale of ongoing remediation efforts, and the implementation challenges. While many banks have made progress in improving their management and measurement of WWR, the survey results showed that this
general trend masks a disparity across the industry both in current capability and in the willingness of institutions to address and, in some cases, acknowledge the risk.

**Key Findings**

A majority of respondents commented that their management of WWR remained a manual process overly reliant on expert judgment, and they acknowledged the need to improve their current capability. Most institutions were focused primarily on monitoring and regular reporting of WWR and relied on passive management through pre-existing credit limits. Very little was done to explicitly price WWR given its complexity and the architectural constraints of the institutions’ risk systems.

Nearly half of all respondents had no current policies or formal governance framework directly related to managing WWR. If WWR policies did exist, they rarely contained escalation or sign-off procedures for wrong way trades and lacked a clear articulation of the group’s appetite for WWR. Even fewer institutions subjected WWR policies and procedures to annual review or independent validation.

In terms of governance, a meaningful distinction was drawn between specific and general WWR. Specific WWR refers to situations where a clear legal or structural mechanism adversely links the exposure at default with the counterparty’s credit quality. General WWR occurs when the mark-to-market of the trade and the counterparty’s credit spread exhibit some degree of positive correlation. A much higher proportion of respondents had developed or were developing policies around specific WWR. Two-thirds of the institutions surveyed could identify trades with specific WWR characteristics prior to execution, although in almost all cases this was accomplished through a highly manual process that banks acknowledged needed improvement and greater automation.

Very few institutions reviewed trades for WWR periodically throughout the life of the trade, although a large minority indicated they were implementing this functionality, given that it will be a requirement under Basel III. A common issue for institutions with WWR policies was that they afforded a great deal of discretion to traders and risk managers. Traders were rarely prohibited from entering into WWR trades. Many respondents commented that, if the economics of the transaction were considered favorable or if it was important to maintain a client relationship, it would be acceptable to make the trade.

The survey found management attitudes were polarized concerning the importance of WWR. Institutions participating in the survey fell broadly into two groups—those with pre-existing WWR capability working actively to improve their management and measurement of WWR, and a significant minority with no WWR framework in place and no intention of developing such capability in the near term. A surprisingly large minority of respondents did not consider
WWR to be a material risk in the context of their operations and made no active effort to monitor or manage it.

Differences in attitudes and priorities concerning WWR remediation appeared to be driven, at least in part, by the regulations. Regulatory considerations were a motivating factor for many respondents in expediting WWR efforts. This was particularly true for banks using advanced counterparty credit risk (CCR) models for regulatory capital (internal model method, or IMM, banks) and for whom WWR initiatives were typically driven by supervisory, rather than internal risk management, pressures.

Conversely, banks on the standardized approaches to counterparty risk commented that there would be no capital benefit in implementing more sophisticated measures and had de-prioritized WWR-related improvements, preferring instead to address structural issues and expedite more general Basel III implementation efforts.

A number of respondents chose to comment on related changes to securities market regulations—for example, the Dodd-Frank Act and the European Market Infrastructure Regulation. A handful of respondents felt the drive toward central clearing could relieve institutions of having to develop sophisticated techniques related to wrong way risk, although most surveyed institutions felt it might simply disguise the problem and remove adequate incentives for institutions to manage and monitor WWR appropriately.

Surveyed institutions had different views on what a comprehensive WWR framework would look like. Many respondents felt the key was to build awareness internally of the limitation of their current CCR framework and to conservatively adjust pre-existing exposure measures to accommodate wrong way characteristics. Far fewer institutions felt the primary focus should be on integrated pricing of WWR via improvements to CCR analytics.

Incorporating WWR directly into the pricing of counterparty risk was acknowledged by all participants to be a highly complex and challenging problem, one for which no universally accepted best-practice solution had emerged. A contributing factor to the complexity appears to be the separation of exposure and probability-of-default models within financial institutions. This structural divide, encouraged by the regulatory framework, has constrained banks’ ability to jointly model credit and market risk factors.

Over half of the institutions surveyed felt that, at the portfolio level, the impact of WWR was still relatively modest. Many banks were unable to justify the investment in improving their WWR framework. WWR improvements were seen to be disproportionately costly relative to the incremental benefit and had been de-prioritized within many of the surveyed institutions in light of more pressing risk and regulatory priorities.

In a similar vein, more than three-quarters of respondents agreed that WWR is the exception rather than the rule and not necessarily a general feature of derivative markets. The vast majority felt their portfolios were more likely to be characterized by a favorable dependence between credit quality and exposure—so-called right way risk. It was widely acknowledged, however, that when trades were wrong way in nature, the assumption of independence could lead to a gross understatement of risk. Affiliated and sovereign collateral, credit default swaps, reverse repurchase agreements, and foreign exchange products were cited as the most problematic areas.

While most banks had made substantial progress in improving their management and measurement of wrong way risk, the survey showed there were still considerable differences across the industry in the speed of progress and level of capability. Some institutions chose not to prioritize earlier WWR remediation efforts because of more pressing risk management and regulatory pressures, whereas others simply did not recognize it as a material risk in the context of their operations.

Looking ahead, respondents felt WWR was likely to remain a topical issue that would receive more scrutiny rather than less from their institutions’ risk management teams, the regulatory community, and the accounting standard-setters.

Survey Participants
A total of 56 large institutions based in the United States, United Kingdom, Europe, Australia, Africa, South America, and Asia completed the web-based survey, which was conducted in the spring of 2012. The survey contained 29 questions, split between multiple choice and written responses.

Survey results were displayed in both geographical and asset-size breakouts to help respondents compare their institutions with their peers. The geographical breakout is divided into five regions: the Americas excluding Canada, Canada, Europe, Asia, and Australia. The asset-size breakdown is by institutions under $158 billion, $158–400 billion, $400–750 billion, and over $750 billion. The asset ranges used were determined by the ABA ranking of the top 400 banks globally by asset size.

Deloitte staff members contributing to the study were Vishal Vedi, Zeshan Choudhry, Rob Rouse, and Nanda Prabhakaran Mani. Also contributing were RMA staff members Fran Garritt, Mark Heaton, and Stephen Revucky. The writing of the published executive summary and final report was undertaken by Deloitte and RMA.