

Edge to Centre – Risk Management Beyond the Crash of 2008

Transparency requires risk management centrality, not just comprehensiveness

The financial text books are full of elaborate discussions of risk. More specifically, risk-return or risk-adjusted return are central to investment theory and trading tutorials alike. Post the 2008 crash, the practical operation of an organisation's financial system will be under pressure to resemble more of the theory. The pressure will be equally intense for much greater transparency on risk, return, and how these are managed.

Those who believe that practice already reflects theory face a challenge. How can they explain how and why gross errors in risk-adjusted return were perpetrated, such as notoriously with mortgage-backed securitisation products? At a more mundane level, consider the real choices available to most people for their long-term retirement planning. A clear picture of risk and return is the last thing on offer from the majority of financial planning and investment firms to their retail clients. Even high net-worth individuals are scantily served with a fact-based view of risk-adjusted return.



Several key changes in the financial services industry must occur in reaction to the pressures for transparency and risk-return management.

There is, of course, a contrary “business-as-usual” view. This holds that banks and other firms, and even their regulators, will be content with a “box-ticking” approach. New risk controls will be treated as mere formalities, while the underlying industry structures and psychology remain much the same. Under this view, the collective industry memory will dim over the next decade. The sensitivity to risk will recede, and the conditions will build up for the next bubble. The cycle of boom and bust will repeat itself with different players and instruments.

Next time, it will not be mortgage-backed securities – but it will be something else with the same deficiencies. Namely, lack of transparency, dodging backward-looking regulatory regimes and with a fig leaf of risk mathematics respectability. Yet it will still be built on the sand of conflicts of interest and speciously precise analysis.

Countering the “business-as-usual” view, two key trends are visible, suggesting “it really will be different this time”. Firstly, the explosive growth of high-tech has transformed the attitudes of the very rich. Billionaires are younger on average than they were: often in their forties or even earlier. These newly rich people will not be content with the complacent banking and investment systems that passed muster with older generations. The newcomers to the super-rich bracket will find the irresistible urge to fix systems – and they will exercise the power of their own investment capital to insist on this.

Secondly, the internet and increased coverage by the established media, has heightened the awareness of these critical oversights to the middle class. Those in their thirties and forties will no longer accept leaving their retirement planning to a cosy cabal of large insurers.

Existing pension providers largely offer lacklustre reporting with low levels of consistent information. They will be held up against the standard of internet benchmarks like Amazon. The hallmark of these ‘upstarts’ is a clear conversation with the customer. This is the very

opposite of what the investment industry has provided for decades. An industry that takes refuge in fictions like standard growth rates, fund reporting divorced from individual statements and other such weak dodges, has a clock ticking on it. Several generations of now very demanding, aware and anxious consumers will see to that.

With both mid-level and high-level consumers increasingly holding the financial services industry's feet to the fire, the impetus for change is real. With internet-based critical scrutiny, individual and collective memories will be longer. How, then, should investment firms, banks and other market players react in order to meet growing scrutiny from consumers – not to mention shareholders?

The main answer is to reverse out of the two cul-de-sacs that risk management has driven down in the past decade or so.

Firstly, risk-return has to be brought back to the centre of the typical financial services firm, whether sell side or buy side. The direction during the last 10-15 years has been for risk systems – and the processes they support – to become passive, upstream consumers of trade and order data. There were some honest and sensible reasons for this, not least to try and assure independent oversight of risk pricing by traders. It was also difficult to add up risk across very different business-lines. This meant that re-calculating risk from scratch in multiple systems was hard to avoid.

Unfortunately, this pattern of “risk as an upstream information consumer” ended up as a parasite and a source of confusion. Indeed, it has become a source of operational risk in itself. The risk aggregation engines have become so Byzantine that they take too long to change. They cannot keep up with the newest business processes and asset classes – which by definition are those in need of the most scrutiny. It is on the leading edge that the next “weapon of mass financial destruction” (to paraphrase Buffett) needs to be detected and contained before it explodes.

The long-term solution is to bring risk, most specifically the pricing of risk, back to the centre of the firm. Leave the underlying mathematical models to the front office. Make the risk aggregation systems thinner, lighter and fleeter of foot. Use rapid-development risk software environments, now they are available, to merge more detailed risk measurements in an accurate, transparent (that word again) way. As for conflicts of interest, these are better addressed by getting the traders' idea of fair risk pricing to the risk managers as fast as possible, in a form they can use to model their own cross-checks and devise appropriate controls.

There is a big, additional benefit here beyond just the more effective management of risks. Making risk-return calculations more accessible enables them to be deployed to address improved and above all, more interactive, reporting to clients. Increase the quality and consistency of the risk-return conversation with the customer, and it goes a long way to meeting the concerns of all those high-level and mid-level financial services consumers.

And the second cul-de-sac from which risk management needs a reverse-gear manoeuvre, at least in part? That is the tendency for risk management systems to become ever more elaborate in pursuit of running the firm optimally – i.e. with maximum profitability – from day to day and month to month during normal market conditions.

Once again, this is an excellent objective, but it has also contributed to the sclerosis of top-heavy, upstream aggregate risk management engines. The focus on short-term profit optimisation has also diverted attention from the big-picture elements that form a “risk radar screen”. Risk and risk-duration weighted remuneration for traders, and their managers, is one aspect. Firm-wide counterparty risk is another particularly topical side of big-picture risk.

In summary, a long-term gradual change of approach is needed in risk management. Fundamental, non-duplicated risk and risk pricing models need to be kept at the heart of the firm, in the front office, yet exposed more readily, widely and fluently. Among the consumers of these models will be the new generation of more agile firm-wide risk systems. As a happy and cost-effective by-product, the clients, including the end consumers of investment

services, can be given a richer, more interactive conversation about risk-return and therefore about their true investment choices. While they gradually engineer the long-term changes, firms also need to address the need for separate, “thin & wide” risk systems that are still upstream aggregators. However, these systems, stripped of “run the business” complexity, can focus on “protect the business” forward vision.

Succeed in all this, and a financial services firm can meet the changes needed by society and by investors. The pressure, and the opportunity, is to become more akin to what is proposed by text books: a transparent, tailored engine for offering investors the risk-adjusted return they want. By achieving this, and explaining it consistently to their customers, a bank, asset manager or hedge-fund can indeed “act today and plan for tomorrow”.

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