

## Correcting the financial tail-spin

*Jet pilots use cockpit simulators to sharpen their reactions to unexpected events. Those working in the 'bear pits' of the financial world should do the same, argues risk expert Bart Patrick.*

Too much throttle and – oops – you've overshot the runway and over enthusiastic use of the joystick means that you've crashed into a mountain. But no-one gets hurt and the pilots themselves – and those who employ them – end up richer for the experience.

It's not the same, however, in the equally fast-moving world of finance where financial institutions can suffer from violent turbulence and their customers can face crash landings through negative equity, bankruptcy and the repossession of their homes.



For years there's been a feast of available credit. Some schmucks have taken out card after card with no hope of ever repaying their debts. Others have been allowed to take out mortgages representing 125% of the value of the house they wanted to buy and, in extreme cases, 10 times the salaries they claimed to have been earning. Then came the famine.

Living beyond one's means is foolish but understandable for gullible individuals who have been bombarded with aggressive credit card advertising and attractive mortgage deals. But some banks should have known better and should have better studied the instruments they use rather than rely purely on auto-pilot as though nothing could ever go wrong. Getting on a plane or taking out a loan both carry a degree of risk that can be carefully quantified. It's plain crazy to think that the skies will always be blue.

### Flying blind

To make matters worse, many in the finance sector were flying blind when the sub-prime crisis struck, first in the US, sending shockwaves around the world.

Through a clever sleight of hand and complex financial instruments bad debt was wrapped up and sold on again and again to the point at which nobody knew who the ultimate debt bearer was. These 'parcels' of dodgy debt were traded globally and, on the face of it, looked copper-bottomed or Triple-A rated.

But the credit crisis has sent the financial world reeling, leading to the nationalisation of Northern Rock in the UK – an historic moment in the history of finance – and the prospect of doom and gloom for ordinary people.

The finance industry has acted fast by trying to slam the stable door by binning the cards held by non-profitable holders and slashing mortgage offers and loans.

To rub salt in the wound, house prices in the UK are tumbling and so are commercial property prices as a result of the ensuing economic downturn.

The focus from now on will be upon customers who are not going to default and to find ways of driving up profit by looking more closely at things like 'lifetime customer value' which means the accurate assessment of the revenue likely to be gained from a customer from the moment they walk into a bank to open an account.

Falling house prices might sound like a good idea to some sectors of the community – particularly first-time buyers – but there's an irony here. A parallel is in the motor industry where prices are also tumbling and offers ever more attractive.

But the problem is that as house prices fall those without sufficient capital to meet ever rising deposit demands will continue to fail to 'reach the bar' to be acceptable. It's the same in the motor trade where 'real' prices might appear to fall but, if you can't get credit, you might have to settle for your old banger rather than buy a showroom model.

### **No easy credit**

The days of easy credit are over and this includes investment banks, high street banks, credit card issuers and ultimately consumers.

The good news is that some pension funds – those with strong portfolios of bonds that remain constant – will be able to mitigate the credit crunch. Pension funds typically hold a range of assets and customers can choose how much of their pension pot should remain in risky areas.

It's all about risk these days and, for financial institutions, that now goes far beyond the European standard of Basel II in terms of capital adequacy.

The finance industry only has a finite amount of money and, whilst it's true that you only get extreme profit by taking extreme risk, there needs to be a balance between risk and profit. To measure this in light of the risk 'appetite' of a business depends on gathering and analysing complex and diverse data.

Even in terms of a common or garden credit card, there's no way that a human being could have an overview of the vast numbers of cards out there and how people are using them. The answer lies in an aggregation of data that goes far beyond traditional methods of consolidated reporting.

### **Hotch-potch solutions**

Bringing data together, however, is further complicated by the way that finance companies have evolved over time through acquisitions, mergers and e-market conversions using different management structures.

They are, typically, a hotch-potch and the software they have inherited is a hotch-potch too. Going back to the flight simulator analogy, it's a huge issue for finance institutions to aggregate risk management information and data quality.

But it can be done, ideally as a front office function where different scenarios can be experimented with. Although it takes huge amounts of horsepower to achieve this, the people in the front office should be able to play with millions of possible simulations without asking the back-office boys to cut new code.

Credit risk, market risk, operational risk, income, expenses and costs would then become transparent to those whose job is to make quick decisions.

The finance world is full of highly intelligent people and software that can bring risk into a palatable and non-technical form, brought to the front-office desktop, will ultimately further help the industry and its customers.

On a wider scale, such techniques could also help the Bank of England to set interest rates by making the 'big economic picture' more accessible.

Having said that, the person who cracks macro-economic modelling will make himself or herself a very rich person indeed!

***Bart Patrick, Head of Insurance Practice, SAS UK.***