Required reading

Over the past year, we have witnessed a unique experiment in what makes financial risk management effective. A succinct supervisory summary of what we have learned should be required reading for all interested parties, argues ***David Rowe***

It is rare that social scientists have the chance to conduct controlled experiments, and the same holds true for risk managers. In the past year, we have probably come as close as possible to observing such an experiment, utterly unplanned as it was. Earlier this year, a group of eight financial supervisors from five countries undertook a preliminary assessment of lessons to be drawn from the past year's painful events. This was published in March in a 20-page overview entitled *Observations on risk management practices during the recent market turbulence*.[1] Broadly speaking, the report's conclusions are as follows.

- **Effective enterprise-wide communication.** "Firms that performed well through year-end 2007 generally shared quantitative and qualitative information more effectively across the organisation," the report said. This allowed some firms to identify potential problems in the structured subprime securities market as early as mid-2006, providing them with "as much as a year to evaluate the magnitude of those risks and to implement plans to reduce exposures or hedge risks while it was still practical and not prohibitively expensive".

One result of such effective communication was development of a firm-wide framework to implement macro hedges if and when senior management decided this was necessary. Absent such communication, individual business units made decisions in isolation. In some cases, these decisions increased rather than reduced exposures as the crisis unfolded. In others, the potential for serious risk to the value of super-senior tranches was not even considered until it was too late.

- **Independent and rigorous valuation practices.** Better-performing firms had a disciplined procedure for valuation of complex or potentially illiquid products. This typically included critical judgemental input and a process for challenging front-office assumptions. Once established, these procedures were applied consistently across the firm. Such firms were also likely to sell a small percentage of positions, if necessary, to obtain actual observed prices. They also monitored such things as collateral disputes for clues to inconsistency with valuations of other dealers. These practices also generated richer insights into the full implications of rating agency models and their results, as opposed to relying on simple letter ratings alone.
- **Funding liquidity, capital and general balance-sheet management.** Better-performing firms had closer alignment of treasury and risk management functions. They included input from all business lines in assessing contingent liquidity risk. They had also developed internal transfer pricing mechanisms that charged business lines for building contingency liquidity exposures that could cause difficulty in a deteriorating market environment. Firms that experienced more difficulties lacked full enterprise-wide inputs and failed to appreciate the growth in contingent liquidity risk associated with new and rapidly growing products.
- **Risk measurement and management reporting and practices.** Better-performing firms had more adaptive risk measurement processes and systems that could rapidly incorporate altered assumptions as circumstances changed. They routinely assessed multiple risk measures, including levels and growth of both net and gross notional amounts and patterns of profits and losses, to provide several perspectives on a given exposure. They were also effective at balancing complex quantitative analysis with more qualitative assessments that could be revised faster in response to rapidly deteriorating market conditions.

Firms experiencing greater difficulties were more dependent on specific risk measures. Often, these incorporated outdated assumptions that proved to be invalid. In addition, these assumptions were frequently not readily transparent and, perhaps partly as a consequence, were not vigorously challenged.

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A must read

The full report also argues for the importance of senior managers being comfortable with the major risks their firms face based on personal experience. It is probably no accident that most of the firms that performed comparatively well during the crisis were headed by executives with some capital markets background.

Other points are raised, and those noted here are elaborated in the full 20-page report. Given the manageable length of the document, *Observations on risk management practices during the recent market turbulence* should be required reading for every board member and senior manager of any major financial institution. ■

[1] *Available at: www.newyorkfed.org/newsevents/news/banking/2008/rp080306.html*

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