AlphaFinance Advisors

Confession of a Risk Manager

Some lessons to be learned

In August 2008, the Economist printed an article called "Confessions of a Risk Manager". We have taken some key points out, hopefully for the reader's benefit.

Expect the unlikely:

- "The possibility that liquidity could suddenly dry up was always a topic high on our list, but we could only see more liquidity coming in the market and not going out of it."
- "A 20% drop on assets with virtually no default risk was inconceivable – though this did eventually occur."

Look for clues:

- "Where is the liquidity crisis supposed to come from? Someone asked in the meeting"
- "We failed to read properly the first sign of trouble with the GM bonds mark down".

Beware of mispriced risks and never assume liquidity is a given. Reintroduce risk specific reserves in the risk/return analysis of a transaction, a business:

- "Liquidity risk was in effect not priced well enough"
- "the was no liquidity charge, little default risk, small positive carry... financed in the liquid interbank and repo markets"

Beware of reasonable assumptions:

- "We assumed that if the market ran into difficulties, we could easily adjust and liquidate our positions, especially on securities rated AAA and AA".

- ”We thought all mark to market positions in the trading book would receive immediate attention because they were published daily” (no jump risk...)
- “We trusted the rating agencies”

Be mindful of the products/situations with no real owner:

- “CDO tranches sat uncomfortably between market and credit risk. The market risk department never took really ownership... and the credit department thought of them as market risk....”

Structuring does not change the fundamental nature of risks:

- “Since they were held in the trading book, many avoided the rigorous credit process applied to the banking book assets which might have identified some weaknesses.”

Make sure you position Risk Management the right way:

- “We were not earning money for the bank. Traders saw us as a hindrance to their ability...”
- “Traders were often exasperated as much by how they were told as by what they were told”
- “Business line was more focused on getting the transaction approved than on identifying the risks in what it was proposing. The risk factors were a small part of the presentation and always “mitigated”.”
- “it was difficult to come up with hard and fast arguments for why you should decline a transaction, when you were sitting opposite a team that had worked for weeks on a proposal which you had received an hour before the meeting started.”