



1st JULY 2008

Please circulate

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**To the Editor**

Do you have risk issues in your organisation or region you would like to share? Email your thoughts to the Editor at [DWC@riskrewardlimited.com](mailto:DWC@riskrewardlimited.com)

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**RISK REWARD UPDATE Q2 2008***Financial Risk & Accountancy Issue***Can your risk solutions cope with change?**

**What an amazing year to be a risk professional.** With the problems of Northern Rock, Bear Stearns and Societe Generale to name but three, risk management has never been in closer focus than is currently the case. In this issue of the Risk Reward update we take a look at the current risk climate and the regulatory responses. We also look for the causal links that have given rise to the current climate of uncertainty. In so doing we hope that our readership will gain an insight into the world of risk in banking and its impact on the global markets.



northern  
rock

There are some clear messages for the risk management industry and many of these relate to stress testing and scenario modelling. The concerns about risk management techniques have been clearly identified within the Banana Skins report which we discuss later in this issue. In brief we believe that all risk managers need to consider the following:

**Stress Testing**

The objectives of stress testing are to take a unitary variable and extend this to a plausible extreme. The Bank for International Settlements have identified that more stress testing needs to be undertaken by management of institutions. The problem has been that management can only see plausible from the current market perspective. Of course plausible is likely to be much more extreme than that. Our first clear message is that stress testing should be extended to include plausible but unlikely events. There can be no doubt that the liquidity position of the first half of this year (or indeed the previous two years or so) was outside of the stress testing conducted by most management.

There can be no doubt that had the management of Northern Rock actually applied a comprehensive series of stress tests, leading to management action, then the current problem could have been avoided.

**Scenario Modelling**

It never ceases to amaze a professional risk manager how the same type of events recur. The problems at Societe Generale are a case in point although in no way unique. Providing staff with the ability to conduct fraud or to mislead management inevitably leads to some party taking advantage of this at some stage.

Scenario modelling, as readers of our Risk Reward Update will know from the past, is used where more than one variable is required to be stressed. It takes information from published events that have impacted upon another institution and applies the lessons to your business. The mistake that many firms make is to take the external event too literally, for that is not the point of the exercise.

## Can your risk solutions cope with change? *Continued from page 1*

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What is clear from Societe Generale and Bear Stearns is that neither firm was able to learn the lessons from other public events and that a potentially avoidable problem became a disaster.

### **Risk Models**

Again this appears as a significant risk within both the Banana Skins survey and also speeches and papers appearing on the web site of the Bank for International Settlements ([www.bis.org](http://www.bis.org)). The problem with risk models in general are as follows:

1. The assumptions that are inherent in the risk models are not clearly articulated to enable management to interpret whether they remain appropriate
2. The risk models portray a specious level of accuracy which neither the underlying assumptions nor the quality of the data are able to support
3. Modelling techniques are inconsistent so the management are unable to gain a clear understanding of the true position of the firm and the actions that they are able to take
4. The models themselves are not regularly stress tested to see how they cope with changing market conditions
5. Risk specialists working in different risk areas tend to favour different approaches. This exacerbates the problem that there is likely to be inconsistent modelling.

### **Senior Management Training**

Many senior management have risen to senior positions during the last economic cycle. Depending on when you consider this to have started it has lasted for some 15 years during which time a benign market for banking has predominantly applied.

Management, including risk management, trained and promoted during this period have not had an exposure to the stress environments of the past, accordingly they may be unable to grasp the current issues and the actions to take in the best interests of the firm. Perhaps they are too close to the issue. It could of course be a fault of the training that has been provided which often focuses on materials provided and designed by academic institutions – theoretically brilliant, practically useless. This is compounded by the confusion and focus of the regulators on expected as opposed to unexpected loss. We shall revisit each of these issues in future issues of the Risk Reward Update and would welcome your views on what you consider to be the key issues of the day. Please sent your ideas to [dwc@riskrewardlimited.com](mailto:dwc@riskrewardlimited.com)

