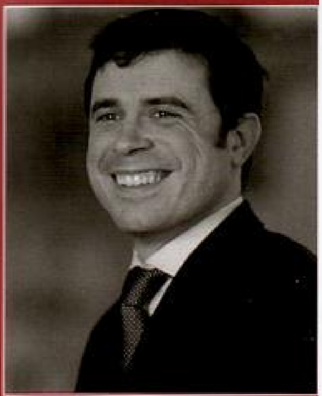
NET2S CAPITAL MARKETS



Insider

Pulling it all together

As the dust settles, where does the banking industry need to begin to fix risk management? Frédéric Ponzo identifies key areas that are in need of a new approach

The future of risk management is in consolidating it. Consolidation brings together credit, market, liquidity and counterparty risks in order to give senior management an overall picture of the risks present in the banking and trading books. This allows management to understand the complex interaction between the different types of risks and enables them to set the correct limits and controls to run the business with the desired profile.

The failure of the silo-based approach to risk management has proved the need to integrate systems and platforms. But banks also need to integrate risk management with trading and other internal operational processes. The best way to visualise this is as a Rubik's Cube or risk cube, which shows the truly multi-faceted nature of risk management. Unique combinations of asset classes, risk types and counterparties are the facets of each smaller cube that make up the risk cube. No single cube can be evaluated in a vacuum or ignored. The large number of possible rotations of the risk cube portrays the complexity of the risk management task while accounting for its interconnectedness.

In addition to better analytics, enhanced reporting is also paramount. Past practices were far too limited, and, to be frank, more akin to box ticking. What is really needed is a more detailed and multi-dimensional approach. The technology needs to improve first to produce this, but the focus also needs to be on the people evaluating the new reports. No longer can risk be sidelined to a mere compliance issue, it needs to enter the boardroom and be understood. More importantly, it needs to be integrated into all the important decisions taken by senior executives, from capital allocation to accepting or rejecting business, down to compensation and incentives.

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In the aftermath of the crisis, it is clear that there was far too much trust in a counterpart's ability to honour a contract, in particular for OTC trades. Two key additional measures need to be implemented, on top of the existing evaluation of the idiosyncratic risk of a given trading partner. First and foremost, credit or counterparty risk needs to be also evaluated in macro-prudential terms: what is the probability for the whole system, or at least a substantial part of it, to default on its obligations? Secondly, the settlement of OTC trades needs to be pooled and centralised into clearing houses. This is already true for most equities markets, and such an initiative is under way for credit default swaps, but swathes of asset classes are still forgotten.

Then, of course, we need better regulation. The public uproar, widespread blame and countless days of finger pointing leaves no doubt that governments will write new rules to tame the "greedy beast". Even if politicians are likely to overdo it, a few clearer, internationally agreed and sometimes stricter regulations are effectively required. They include tougher capital adequacy requirements, increased transparency and regular "war games" or stress tests to check the resiliency of the banking system as a whole.

Fixing risk management is just one part of the puzzle in restoring health to the market, but it is an important one. Banks can simply not afford to ignore their risk posture anymore; and decent profits will only return if they invest and change their risk management practices. Good risk management can literally pay off.

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