

Prevention better than cure: PRiM on recent market turbulences

By Margaret Ferns

The Simple Rules of Risk (Eric Banks/Wiley 2000) defines risk as, "The uncertainty surrounding the outcome of a future event." From this definition; risk management can then be broken down into five categories. "Financial risk (liquidity, interest rates, processes, systems, credit/counterparty); operational risk (Basel II, people, processes, systems and external events); business & strategic risk (competition, reputation, industry change, client demand, R&D, legal, regulatory, political and accounting); framework for risk analysis (time, scenarios, measures, benchmarks, internal/external drivers) and process flows for risk management (measurement, reporting, analysis/assessment, decision and action)."

Thanks to the increasingly complex global business environment, the profile of risk management has been on the up in recent years. The almost incessant influx of new rules and regulations and the basic fact that the world we all live and work in has dramatically changed such that hitherto seldom used terms have become part of daily vocabulary - terrorism, war, insurgences, money laundering, corporate scandals and structural weaknesses etc. - means that the role of risk management has become more and more crucial to business.

As companies increase in awareness of the importance of risk - understanding and managing

it - the more time and money is being invested in the function and the more embedded it is becoming into the business' daily activities. Recent events like the US sub-prime crisis and subsequent liquidity crunch and the scandal at Société Générale prove that this is no bad thing. After all, much of the market turbulence and loss of investor confidence these issues have sparked have come about due to lack of sufficient controls that were regularly monitored for their effectiveness.

PRiM is the Luxembourg Association of Professionals in Risk Management and, in a recent interview, board members Marco Zwick, Ravi Beegun and Pascal Denis joined Chairman Michael May to discuss the importance of efficient risk controls in the light of these recent events and assess the evolution of the risk management function in the Grand Duchy.

Know your product & check your checks

May began by saying that, "It is important to clear up a major misconception about risk. Risk is not necessarily bad; after all in the financial sector no risk means no profit. A risk manager's job, therefore, is to identify potential risk, set up controls and make sure they are monitored on a regular basis to ensure that the



Ravi Beegun

risks accepted by an institution remain within its risk tolerances."

In fact this last point played an important role in the US sub-prime crisis. May explained, "It was a time of economic growth and low interest rates, so there was a lot of pressure from investors and shareholders to generate profit. As this worked for a time, no-one questioned that the risk models put in place continued to match the financial instruments." And everyone was at it. As Pascal Denis put it, "When there is success, you don't want to be the only one not in on it."

Marco Zwick said, "The problem is that financial instruments have become so complex that often their nature isn't fully understood. The danger is that they can change very quickly and what was liquid can easily become illiquid." Ravi Beegun

added that the increased use of securitisation at that time also meant that, "A lot of cheap funding came from outside banks. People were investing in high return vehicles with low liquidity. In a boom this is okay, however in a downturn..." The effects are still being felt. Indeed Zwick said, "The issue has contaminated the financial markets and consumers have a lot less confidence. The use of risk transfer vehicles, like securitisation, means that it is very difficult to see, even now, where ultimate responsibility for the risk lies."

The global impact of the sub-prime crisis is not likely to go away anytime soon. May explained that, "In the US it was too easy for people to invest in houses, often beyond their means. In some cases people were falsifying their revenues and lenders weren't checking



Michael May

their claims because at that time everyone was making money." The problem now of course is that there is a massive shortfall in savings in the US and, according to René Karsenti of the International Capital Markets Association (speaking at a recent PRiM lunchtime conference), given that US consumers spend in the region of 9.5 trillion US dollars (representing 72% of GDP), "This issue will undoubtedly have an impact on real economic growth." Not good news for European economies which are still export driven.

Seek error patterns & check your checks

Still smarting from the liquidity crunch, Europe is now asking questions in the aftermath of the Société Générale scandal as "rogue trader" Jerome Kerviel

totted up in the region of 4.9 billion euro (7 billion USD) in losses for the French bank. "How could this possibly have happened?" According to various articles in the international press Eurex, one of Europe's biggest exchanges, began issuing warnings about Kerviel's actions as far back as the 7th November 2007, claiming that he had engaged in several transactions that had raised red flags. An article in the International Herald Tribune reported that it took Société Générale until the 20th November to reply to this alert, at which time it blamed the need for after hours trading on the increase in volatility in the US. Not satisfied with this explanation Eurex apparently sent a second e-mail to the Bank, which was not replied to until the 10th December.

Five weeks later on the 18th

January 2008, Kerviel's activities set off further alarms; only this time it was too late - 4.9 billion euro down and the Bank set about unwinding his financial positions. However, rumour would have it that Kerviel was working in an environment which encouraged this type of risk taking. The same article in the International Herald Tribune stated, "Overlooking the warnings from Eurex was only one of a series of missteps by Société Générale... The 144 year-old bank allowed a culture of risk to flourish, creating major flaws in its operations that allowed rogue traders' activities to go undetected." An enquiry by a special committee of independent directors is currently underway.

As the facts of this case are not yet clear the representatives of PRiM felt it would be wrong to comment on recent speculation in the press. Nonetheless, they did feel that there are lessons to be learned. "The common trend is for losses to be analysed in detail, but often there is a lack of attention on how profit is generated," said Beegun. He feels that this is a bit like closing the stable door after the horse has bolted. "What we should do is look at error patterns, whether a position is up or down." Zwick added that, "It is also a question of corporate governance. As risk management is about managing risk (and not about not taking

risk), each organisation has to establish its tolerance to risk and choose a risk profile." But this is just the beginning; maintenance is equally essential...

"It is important not to then assume that your risk is taken care of. Checks and controls must be continuously monitored for their effectiveness and no assumptions made," said May. Beegun added, "Make sure that the people at the top are on board. They need to understand the nature of risk and know exactly how profit is generated."

There's always a price...

Market turbulence also makes the job of pricing very difficult. "Volatility and the increasing complexity of financial instruments are increasing the chances of NAV (Net Asset Value) errors," said Denis. May agreed adding, "In today's markets, assets held are starting to include more and more bespoke products which makes it increasingly difficult to see what lies underneath and this makes reliable pricing very tricky."

Zwick brought up another important point. "In Luxembourg the CSSF has laid down a framework of what we should do in the event of an error in NAV calculation. This is extremely helpful but don't forget that we



Marco Zwick



Pascal Denis

» distribute all over the world. In Asia, for example, there is absolutely no tolerance for error, so this makes getting it right the first time imperative."

Fortunately, very few funds have had to be suspended due to pricing errors. However in a time of market turbulence and increasingly complex financial instruments how is such a track record to be maintained? Beegun's response was, "What is important is the pricing process. It is imperative that the board of directors and conducting officers take a more active role in pricing in order to understand how it is achieved."

From score-keeping to strategic partnering

The Economist Intelligence Unit (EIU) recently conducted a global survey of 435 very senior executives. The survey reached CEOs, CFOs, heads of internal audit and audit committee chairmen as well as risk managers and compliance officers in a broad cross section of industries. The aim was to assess

the evolution of risk management. Following the EIU's research KPMG International commissioned the publication of the report, "The evolution of risk and controls: From score-keeper to business partner."

The report found that, "The profile of risk management has been rising steadily for several years," and that, "As risk and control functions receive greater boardroom attention and become more deeply embedded in the organisation, expectations of their aims and outputs are changing...namely, that they make a measurable, positive contribution to the business." So, globally, risk management is gradually shifting from wealth preservation to wealth creation. Is this also the case in Luxembourg?

"There is certainly greater sensitivity towards risk management in Luxembourg, especially in terms of corporate governance," said May. However Denis added that, "We still need to get rid of its negative image; it is not about policing the business, risk management is very much an enabling function. It is solution oriented; about anticipat-

ing potential difficulties in order to reduce risk."

PRiM is working hard to demonstrate this fact to the Grand Duchy. "There are more and more conferences and workshops being organised on risk management related topics, which demonstrate its value added," explained May. "People are beginning to see that it is not just about controls." Indeed, Zwick sees the risk management function in the investment funds industry evolving in the coming years such that, "it becomes more and more about investment risk analysis."

As awareness of the potential "measurable positive contribution," risk management can make increases, PRiM expects to see the profession in Luxembourg grow, even be stretched, in the coming years. May said that, "We are an evolving profession in Luxembourg and need more dedicated functions but as awareness increases, so will demands on the profession." Therefore, among its major challenges as an association in the coming years will be to

attract new talent to the profession and ensure solid training. "We need to make the profession interesting to young graduates," said Zwick, with Beegun adding, "as well as ensure training in complex financial products." As stated before, a large part of the sub-prime crisis has come about thanks to lack of understanding of such products.

To this end PRiM is working with training partners in Luxembourg like the IFBL (the banking training institute in Luxembourg). "We have very good introductory and top end training thanks to this partnership, but we need to work on developing a middle range offer." The Association is also currently working on developing a set of risk management principles to act as a backbone for the profession. "Not in any prescriptive way," explained May, "but more to serve as guidelines for the profession in the Grand Duchy." Further input from PRiM will be included in the investment funds feature planned for next month's BR.

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