INDEPTH

VENABLE LLP

RISK MANAGEMENT IN THE FINANCIAL SERVICES INDUSTRY

REPRINTED FROM:
MAY 2010 ISSUE

© 2010 Financier Worldwide Limited.
Permission to use this reprint has been granted by the publisher.

FW MAGAZINE

FINANCIER WORLDWIDE corporatefinanceintelligence

RISK

Risk management in the financial services industry

BY MUAZZIN MEHRBAN

By its nature, the financial services sector is heavily interconnected, so certain types of risk can surface and spread very quickly. This makes it essential for institutions to understand how risk – especially financial risk – circulates through their operations and how it might affect business performance. Unfortunately, efforts made to mitigate risk can sometimes be misdirected, which consumes valuable time and resources while the actual risk continues to escalate. Experts suggest that financial institutions need to improve the way they identify and cost risk in the future. Part of the problem stems from the cyclical nature of the market. In stable times, firms grow comfortable taking risks and optimising their strategies to generate lucrative returns. But when the environment turns less certain and more dynamic, as in the recent economic downturn, many firms discover they are inflexible as risk events materialised, and unable to adapt.

This is not to say that financial institutions ignored or shirked their risk management responsibilities. In the lead up to the credit crunch, they were generally guilty of overestimating the upside and underestimating the downsides of a given opportunity. "When recent experience of risk-taking is positive and when the rewards are perceived as high, this is an intoxicating mixture that can lead to unwise exuberance," says Neil Cantle, a principal and consulting actuary at Milliman. "All too often, people think that they are controlling a situation which they really have not taken the time to understand properly. When trouble hits, it can unravel very quickly and the critical 'point of no return' is passed. The problem in complex situations is that time-lags in information flows and action-taking can make it exceptionally difficult to know where that critical limit is – and once you have passed it, then that's it." Firms that can interpret complex scenarios and predict their consequences more accurately have a much better chance of reducing risk where possible, and responding effectively to risks that do become a reality.

Identifying risk

Risk management merely papers over the cracks if it fails to build appropriate safeguards. Even when valid risk data are produced, there can be a disconnect in the way firms react to it – sometimes for the simple reason that managers do not fully understand the data they are reviewing. Companies also need to build in sufficient time to mitigate any risks which they identify. The pace and scope of today's markets demands that firms respond quickly to deflect any negative impact; corrective plans which call for months or even weeks of action may be pointless if the threat does its damage within days. Often, data can misrepresent the potential consequences of a threat on business performance, which leads management to take steps to mitigate that risk improperly.

But new technology is helping financial institutions improve their approach to risk. In terms of portfolio reporting, complex risk-based models and stress tests are now widely available, from leading multinationals right down to local banks. In theory, this should enhance stability within the system, as institutions of all sizes can utilise the information produced by these models and integrate the results into their risk management processes. In practice, however, the technique does have its flaws. "While the technology may be readily available, the use of data-driven, risk-rating models and portfolio management reporting is still far from the ideal standard," says Joseph T. Lynyak III, a Financial Services partner at Venable LLP. "In order for financial institutions to effectively understand and mitigate risk, they must adopt technology at a faster pace than they have in the past. Regulatory pressure on financial institutions will play a significant role in their adoption of advanced risk management technologies." In addition, the perceived assurance provided by better modelling can encourage firms to take even greater risks. Even though a company's overall risk profile may be reduced, it may be exposed to exotic or extreme threats which generic tests do not take into account. Although advancing technology allows institutions to increase their risk appetite, on the assumption that better systems will mitigate more threats, any failure to control major risks for which firms are unprepared will be magnified by the fact that most of the market will have missed them too, since they are all operating under similar models.

Regulatory changes are also expected to affect the manner in which the financial sector responds to risk. Put simply, firms will need to comply with a framework that sets limitations on risks resulting from their business strategies and practices. In particular, firms are going to have to show better alignment of solvency capital to risk taking; if a firm is intent on taking greater risks, it will need to set aside more capital as a contingency. "Most firms clearly already do this to some extent, and so the impact on particular firms depends upon how well this has been done in the past," suggests Mr Cantle. "The alignment of capital and risk is already focusing firms' minds on whether they are being adequately compensated for those risks and are actively considering the product designs which they are prepared to offer and the prices at which they are prepared to offer them. There will also need to be an element of consumer education about the value of certain product features if companies are to stand a chance of charging a suitable amount for providing them." Regulatory oversight may even extend to the treatment of individual loans and assets, where firms could be required to produce specific, uniform, risk related information at the micro level.

Responding to risk

But incentivising institutions to adopt comprehensive, integrated risk management pro-

cesses could be a stumbling block. Companies which already have sound risk management systems will not take kindly to being treated in the same manner as their competitors with shortcomings in this area. "As an incentive, will financial companies with viable risk management systems be granted lower deposit assessments or capital requirements vis-à-vis their counterparts that lack adequate risk management systems? Or will regulatory bodies take administrative action imposing cease-and-desist orders, fines or similar penalties on companies whose risk identification systems are found to be inadequate?" asks Mr Lynyak. He adds that another, perhaps more difficult issue for regulators to resolve is their ability to accurately measure risk simultaneously at individual institutions and across the entire financial system. Serious errors were made by international banking regulators when promulgating risk metrics in recent years, and industry observers are hopeful that these dramatic analytical failings will not be repeated.

For financial companies, regardless of how stiff the current regulatory environment may be, a good risk management strategy is essential to a firm's confidence and its willingness to take risks. "Risk strategy needs to be responsive and adaptive and fully embedded into the core of the business," says Mr Cantle. "A 'control exoskeleton' is not going to do anything other than make the business underperform. Culture is the key to any risk management system." He adds that if people genuinely understand which risks are acceptable and how best to respond to them, a business will be primed to keep itself out of trouble. But a concrete risk system, which is based on hard rules and procedures, could miss important clues about emerging risks and slow the response mechanism. In addition to an appropriate risk culture, firms should also look to establish a set of risk limits, monitoring tools and control mechanisms, all of which should be underpinned by an understanding of how risk behaves within an organisation. Experts suggest that when looking to understand risk, firms should take a holistic approach, as sometimes understanding particular features through methods such as modelling will not give a full perception of how comprehensive risk dynamics are generated.

Although there are costs associated with making risk management more efficient, there are many benefits of doing so. An integrated system will help to unify management functions in bank processes – including product offering, funding alternatives, credit risk and default risk – which can lead to a smoother operating environment, according to Mr Lynyak. "Furthermore, assuming that risk management will be implemented on the individual loan or asset level, this enables management to segment and analyse risk on a consistent basis, regardless of the level of analysis. For example, a unified risk management system could significantly improve bank product development, which for many institutions today is frequently reactive and judgmental," he says. Crucially, firms with better integrated risk management will be welcomed by the market and could enjoy a boost in share value. Transparency across the market is needed to identify the initial signs of systemic collapse and steer the financial sector away from disaster in the future.

Against the backdrop of current economic strife, the benefits of risk management in facilitating institutions' evaluation of their operational strategies is a necessary element that should be implemented throughout the financial services industry. Furthermore, at the sector level, it can bring greater stability by building mutual trust between firms, investors, regulators and consumers. Although risk management cannot deliver 100 percent certainty, it can minimise the impact of failure and narrow its shockwaves. Ultimately, the right culture and infrastructure allow a financial firm to create value for capital providers in an atmosphere of trust among company stakeholders, who are clear on the risks involved in generating revenues and returns. ■

Joseph T. Lynyak III is a Financial Services partner at Venable LLP. He can be contacted on +1 310.229.9660 or by email: jtlynyak@Venable.com.

Joe Lynyak focuses his practice on the regulation and operation of financial service intermediaries. Mr. Lynyak's practice includes the representation of foreign and domestic banks, savings associations, holding companies, mortgage banking companies and their subsidiaries and affiliates. He provides financial intermediaries advice in the areas of strategic planning, application and licensing, legislative strategy, commercial and consumer lending, examination, supervision and enforcement and general corporate matters.