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## Risking Nothing, Risking Everything

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# RISKING NOTHING, RISKING EVERYTHING

**Credit mess brings risk management back into focus, and the stakes are huge. How do we get it right this time?**

In its 50-page April 18 report to shareholders explaining its huge write-downs, **UBS** admitted it was unaware of its total subprime exposure prior to last summer.

Incomplete data and hedging were just some of the reasons UBS' risk managers were unable to contemplate the gravity of the situation. "Hedging resulted in positions being netted off and therefore not showing up in the overall position data," the report says.

UBS was adamant its difficulties were not its alone: "Based on publicly available information, UBS believes that its approach to the risk measurement and valuation of structured credit products reflects issues which were not unique and that a number of other financial

institutions with exposure to the US subprime market used similar approaches."

As Wall Street has learned in a most painful way, UBS was right.

So how did things go so horribly awry?

"I don't think there is a silver bullet where you can point to one thing that went wrong—there are a number of things which contributed to poor risk management which I think you'd have to characterize Wall Street as collectively guilty of over the last year or so," says **Jonathan Chenevix-Trench**, former chairman of Morgan Stanley International.

Chenevix-Trench, who left **Morgan Stanley** after 25 years in late 2007 and was offered the position of chief risk officer before he departed, says there was an insufficient ability to focus on big risks because risk officers and managers were too focused on minutia. "You can verge towards a system which has everything in tight, neat boxes, but you have to be able to sit back and actually look at

**By Joshua Hamerman**

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the pool of risks and the balance sheet across the institution,” he says.

Another problem is that risk managers were using the wrong calculations when computing levels of risk for complex products. Much of the data was based on assumptions that the housing market would remain robust and that mortgages which originated in 2005, 2006 and 2007 would comport with the performances of mortgages from

**Deloitte & Touche.** “More often, the person who was shot early on was the CRO, when in fact the CRO had fairly well-developed processes in place but the broader organization wasn’t paying attention to what they were saying.”

The appetite for risk used to be higher, but the instruments on which bad bets were placed are still in use. “There are still some firms dealing in CDOs—that market’s not dead—but

sult, all the critical pieces of information they were designed to collect were not combined properly. “Not all of that information was being effectively managed at the enterprise level, so you had all these little silos which prevented a real-time big picture of what was going on,” says **Adam Honore**, a senior analyst at **Aite Group**. “One of the biggest challenges associated with risk management is core data integration.”

Everson agrees. “One of the challenges for a number of organizations is having the right information that cuts across the company and is shared in a timely fashion,” he says. “Some business groups saw early signs that the residential mortgage market was starting to tighten, but that knowledge never made its way across the organization to other business groups within the same institution.”

Recruitment of risk professionals is not new, but events of the past year have accentuated the need for strong chief risk officers, says **Pamela Martin**, director of regulatory regulations and communications at the **Risk Management Association (RMA)**. “Once we get through this, there will be important lessons that can hopefully prevent some of the mistakes of the past,” she says. “Rather than memories fading, hopefully better risk controls can be put in place, particularly so folks can understand the interplay between credit and market risk. A lot of stuff that was in trading books as market risk turned out to be credit risk.”

Dissatisfaction with data collection software is also not a recent development. In a survey of 104 global institutions conducted by the RMA last year, none of the participants described the quality of their employers’ data as “ex-



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prior periods, even though the underlying borrowers were different.

“Often, scenarios used to value and manage positions used assumptions that didn’t test to the extreme market movements realized over the last 12 months,” says **Miles Everson**, a risk management partner at **PricewaterhouseCoopers**.

Many financial institutions simply did not understand the asset classes they were investing in. “Many shops thought they were in the moving business, but when liquidity evaporated, found out they were in the storage business, never intending to hold assets for an extended period of time,” says Everson. “Very few of these institutions had clear line of sight into what would happen if there was a double-digit percentage drop in the housing market.”

One of the most important factors, of course, is the culture at Wall Street firms. “It’s vital that you encourage an atmosphere where people can challenge decisions and bring up risks,” says **Chenevix-Trench**.

“There’s the organizational risk management process and then there’s the risk management functional process—both of these elements failed,” says **Scott Baret**, partner and head of US credit risk advisory services at

there’s a question of whether there are sufficient risk management protections in place to make sure they’re not exposed to more risk than they already have,” says **Ellen Zimiles**, chief executive and co-founder of **Daylight Forensic & Advisory**. “There is a fear in investment banks—they’re looking for other areas to invest in and how they can hedge what they’ve got.”

Financial institutions make up a large percentage of the clients Zimiles’ firm works with. When speaking with lawyers at big banks last year and even earlier this year, “It seemed like some institutions didn’t want to know what was in the underlying securities,” she recalls. “I heard many lawyers say, ‘We’ve got it covered by tranches,’ and it turns out that reliance on those tranches may have been misplaced.”

Firms’ data systems were created to perform disparate tasks, and as a re-



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cellent.” At best, only “above average” data was the order of the day.

“That’s been a complaint of the industry for some time,” says Martin. “There have been innumerable data-cleansing exercises that the industry has undertaken, but unless you get the data correct at the point of entry and establish a system that requires data to be verified continuously, then you’re fighting a losing battle.”

### Hedge funds understood

Hedge fund indices show overall hedge fund performance has been roughly flat over the last 12 months, while the **S&P** financials index was down 35% over the same period.

“The more outspoken hedge funds point out that the less-regulated hedge fund industry survived the crisis well and dampened market volatility, while the more-regulated banks suffered most of the pain and contributed to market volatility,” says **Rajiv Bahl**, director of portfolio and risk management at **Financial Risk Management**, a global fund of hedge funds with \$15 billion under management. “If anything, this crisis has highlighted how the better hedge funds and investment firms view risk management as an integral part of everything they do.”

The hedge funds that made headlines with high-profile blowups last summer had a few billion dollars in assets under management, lower than the tens of billions in write-downs suffered by investment banks.

Even hedge funds that navigated seamlessly through the credit crisis, though, are more careful because many of them receive financing from commercial and investment banks such as Morgan Stanley and **Goldman Sachs**. “Intellectually, their risk appetite is the same as it’s always been, but now they’re more cautious because of the fickle asset liquidity and financing environment,” says Bahl. “From our conversations with hedge fund managers, it appears that most are looking to raise risk-management standards. Some are doing it after the fact, having suffered losses, and others are saying, ‘We were

doing this all along and did well, and how can we do it slightly better?’”

One way fund managers are looking to “do it slightly better” is via shrewder negotiations with prime brokers. When hedge funds finance positions with prime brokers, there are usually “haircuts” attached to the assets. For example, prime brokers could tell hedge funds that for every \$100 of a particular equity product, they will lend \$85 and the remaining \$15 will have to come from the hedge funds.

However, the better-prepared hedge funds negotiated “evergreen facilities” with prime brokers, to prevent prime brokers from changing haircuts on the spur of the moment. Evergreen facilities usually require prime brokers to give notice of at least 60 days if they change haircuts. This allows hedge funds sufficient time to reduce leverage or move positions to a different prime broker.

Some hedge funds already have longer-term facilities in place, while others are seeking to do so.

“A few higher-leverage funds collapsed because their haircuts were changed,” says Bahl. “Others were afraid it would happen to them, so they quickly de-levered their balance sheets, sold assets into illiquid markets and suffered losses—now they’re saying, ‘We don’t want to be exposed to that risk again, so let’s renegotiate.’”

### Cultural changes

Gradually, financial services players are learning from the mistakes that led to the current crisis.

For example, says Honore, “Data projects used to be incredibly difficult to sell to senior management for funding because there’s no tangible return on investment, but now with all of the very public risk exposure, these projects are a lot easier to

## RECENT RISK MANAGEMENT APPOINTMENTS

- **UBS:** Philip Lofts was appointed group risk chief operating officer and Thomas Daula, formerly Morgan Stanley’s chief risk officer, was named chief risk officer of the firm’s investment bank. Daula also takes on responsibilities of the I-bank chief credit officer.
- **Merrill Lynch:** Noel Donohoe and Edmond Moriarty were named co-chief risk officers in January and September, respectively.
- **Citigroup:** Brian Leach was named chief risk officer in February and reports to CEO Vikram Pandit. Richard Evans was hired as chief risk officer for the Institutional Clients Group, which includes investment banking operations.
- **Lehman Brothers:** Chris O’Meara, formerly chief financial officer, was tapped as global head of risk management.
- **Morgan Stanley:** Kenneth deRegt was hired as a managing director in the chairman’s office to assist with risk management.
- **State Street:** Maureen Miskovic joined to fill the newly created role of chief risk officer.
- **Ambac:** David Wallis was selected to become chief risk officer, a new position.
- **CIFG Holding:** David Rockwell was hired as chief risk officer.

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articulate and acquire funding for.”

Firms are also making additional efforts to implement workflow solutions by installing business processing systems which provide more audit capabilities and accountability. These workflow initiatives cut down on paper reports and phone calls because they display as much information as possible on one computer screen.

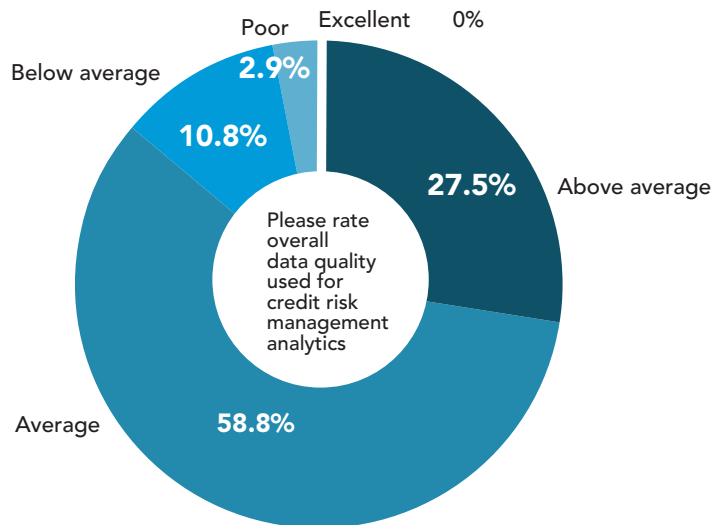
While risk managers are an important part of the equation, they are not the only forces at work in a financial institution. “Subprime issues weren’t really a problem of the risk managers not knowing—it was a gamble people took and it didn’t pay off,” says Honore. “A risk manager’s job isn’t to eliminate risk—it’s to create awareness and mitigation strategies. Senior managers have to choose to implement them.”

A balance needs to be struck. “Banks are there to make money and risk managers are there to mitigate risk, but banks make money off of risk,” says Honore. “I’m sure people are much more aware of overall exposures now and paying a lot more attention to risk managers and risk management systems about over-exposure to products or entities, but as far as people hunkering down and completely mitigating risk from trading, that’s not going to happen.”

Boards of directors are also looking to increase risk oversight. “Risk committees have been associated with boards for a while, but I’m sure they want more awareness because they don’t want to wind up in front of a Congressional committee or on the front page of *The Wall Street Journal*,” says Honore.

Banks need to make sure data programs with semi-artificial intelligence mechanisms—which can, for example,

### SURVEY SAYS...



Source: Risk Management Association/Automated Financial Systems

catch errors in loan applications—are inserted into data programs, says Martin. Employees should also be given stronger incentives to make sure their data entries are correct, and banks must have strong chief risk officers who understand institution-wide risk. “We’ve heard a lot that risk was man-

Zimiles expects risk management infrastructure and personnel shakeups to continue at investment banks, to the point where “what risk management organizations look like today isn’t what they’re going to look like in six months to a year,” she says. Banks will continue to pursue risk managers who are more

Stanley’s former chief risk officer, as its investment bank’s chief risk officer. Morgan Stanley hired **Kenneth deRegt** to give its risk management division a makeover. **Citigroup**, meanwhile, made **Brian Leach** chief risk officer in February and added **Richard Evans** as chief risk officer of its Institutional Clients Group, which includes investment banking. **Lehman Brothers** tapped its former chief financial officer, **Chris O’Meara**, as global head of risk management in September.



**PwC’s Everson: ‘Many shops thought they were in the moving business, but when liquidity evaporated, found out they were in the storage business.’**

aged within its own silo—credit risk was managed within credit risk and market risk was managed within market risk—so there was not a proper understanding of the integration of those two risks,” says Martin.

The ensuing credit crisis led to many senior managers, as well as chief risk officers, being replaced, and in some cases forced banks to create new risk management positions. UBS appointed **Philip Loftis** as group risk chief operating officer and **Thomas Daula**, Morgan

knowledgeable, and will have to pay more to retain them.

In addition, says Deloitte’s Baret, “Risk management can’t be all about risk management function—it has to be about the way an organization approaches risk management.”

Another crucial change, says Everson: “Anybody approving a transaction or portfolio structure has to understand its purpose and related risks.” **ID**

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