

Summary of presentation by Alan Craft

Risk management in financial services: we do the impossible everyday – miracles take a little longer

Four key themes come through consistently when one considers the relationship of Risk and Behaviours. The recent sub prime crisis and the resultant credit crunch serve to underline them. Indeed, the current situation suggests that there are very few new elements at play; rather an affirmation of long known truths.

A good example of the above can be found in reading the literature on the current problems of UBS and the findings about them at the time of Long Term Credit's demise in 1998. A decade on and the same issues appear and the same recommendations on the Risk and Behaviour connection apply.

This suggests very strongly to me that no amount of external regulation or audit can replace the value of a sound culture within an institution. To support this, the four themes have to be understood and managed:

1. Visibility

Being transparent within the organisation and to those stakeholders outside is vital if the strategy is to work long term. Much of current dogma on the subject tends to force the issue on to those who are ill prepared. If the groundwork is not there, then it will not be real.

Annual reports and especially notes to the accounts are an example of decreasing visibility even though they purport to show greater transparency. The new IAS rules have tended to add to this problem.

2. Complexity

Leading edge banking products are complex in themselves; made more so when they are traded on a global basis 24 hours a day. The level of computing power at the disposal of some very astute minds is daunting. Not only cannot regulators keep abreast, I doubt more than the most sophisticated investors do so. But in a world that is chasing yield, the pressure to buy is high.

The rules on valuations and disclosure that accompany such products are also in catch up mode so how does anyone know real worth when a market moves heavily?

3. Budgets

Investment banks are very top heavy institutions...huge front offices supported by modest back and middle office functions. This is true in terms of number of employees and even more so in terms of compensation totals and investment spend. Ironically the most similar type of financial institution in this regard is the fund manager.

The inherent operational risk run by such organisations is huge. Although some do it well, many do not and the consequent fall out can be considerable. Aggressive budget targets in such a leveraged environment lead to some very basic behaviours that add rather than subtract risk to the firm.

4. Incentives

In the end, behaviours are determined by the incentive framework that exists within a firm. This encompasses both financial and non financial incentives...who gets rewarded and who gets applauded....what is the house style and culture.

Banks do not train bankers any more. They train traders, salesmen, back office, compliance etc...Silo and parochial behaviours often overrule any others. One has to feel for new CEO who is promoted from equity sales and has had no experience of other parts of the business. By default banks often appoint the FD because he or she has knowledge of those businesses but no experience of markets or sales.

The determination of risk appetite in such organisations is rightfully a difficult task, requiring all sorts of balances and trade offs. It is made doubly difficult if the firm has no clear cultural base or incentive profile by which to assess its appetite. Banks that blow up twice in 10 years clearly lack these....UBS and Citi being examples. But then so do Bear Stearns and Northern Rock which pursued strategies that were beyond their capabilities.

We have not seen the end of the credit crunch and may not for another 12 months. Its fallout will change many aspects of banking but some home truths should not change, but rather the way they are executed should.