

The Lessons of Risk Management

Major trading losses signal the need for better risk management systems.

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At the beginning of the year, everyone working in the investment and trading world knew what equity derivatives were - but almost no-one else did. No-one except middle management at Société Générale had heard of a junior trader called Jérôme Kerviel.

Within two weeks however, equity derivatives had joined sub-prime as something that had crossed over into the mainstream. And Kerviel had joined the rogue trading hall of infamy: a Facebook folk hero who brought major crisis to one of France's biggest financial institutions.

It's not a problem that is confined to the trade of pure financial instruments. Six weeks later, at the end of February, a wheat trader at MF Global, one of the world's biggest commodities brokers, lost \$141.5m by making 'unauthorized' trades. Although the amount pales before the €4.9billion that Kerviel allegedly cost Société Générale, it wiped more than a quarter off the value of the company's shares.

The problems at MF Global, believed to be the largest suspected unauthorized trade loss in agricultural markets, follows the 2006 bet by Amaranth in the natural gas market, that lost \$6bn; the loss of about \$200m in copper futures by the Chinese government agency in 2005; and the exploits of one of the most infamous rogue traders of all, Yasuo Hamanaka, who lost \$2.6bn in the copper market in 1996.

While we wait for the results of the investigation into the meltdown at Société Générale, there are some immediate lessons to be drawn for any organization involved in trading activity, the most important of which is to make sure you have robust and resilient risk management systems in place. French economy minister Christine Lagarde summed it up perfectly when she told reporters, "There is a risk which is operational risk, as opposed to market risk, which must be taken more seriously into consideration."

The operational risk that she referred to is not just the losses related to an individual trade going wrong, but the negative impact that inadequate risk management can have to the whole enterprise.

Experts have long been explaining the potentially massive operational costs of not managing and controlling risks in a trading environment. The list is a lengthy one, including government enquiries, shareholder lawsuits, job terminations, earnings restatements, severe adverse publicity, loss of market capitalization, liquidity crises, volatile earnings and increased cost of capital. Ticking all these boxes, SocGen in particular has just proved - graphically and uncompromisingly - how right they have been all along.

But what does robust and resilient operational risk management look like? For many organizations that's a very uncomfortable question. Because at its heart operational risk management requires you to know what every aspect of your business looks like. It's a function that is built on transparency and communication, giving decision makers access to instantaneous, accurate and actionable information across the enterprise.

Smart decisions require all business groups, including risk management, operations and finance - as well as trading - to work off the same real-time data. Even for firms that profess a strong commitment to risk management, and have established unimpeachable processes, the positive talk is nothing without the information flow in place to back it up.

That means that any organization that still silos information simply does not have effective operational risk management procedures. Multiple, patched-together systems and individual spreadsheet applications, separated by organizational divides and inter-departmental rivalries, are counter-productive in terms of managing enterprise risk.

Instead, today's complex and volatile global commodity market requires trading organizations to have a single, integrated, real-time view of all physical and derivative transactions, coupled with straight-through processing from front all the way through to back office.

With the right system, data is entered once at the source and everyone - from executives who measure performance through to compliance officers, schedulers, risk managers and portfolio managers on the execution front line - gets accurate information at the exact moment they need it. What's more, straight-through processing guarantees one version of the truth across all business units, eliminating duplicate efforts and potential for errors. It enables companies to set limits and control workflow, integrating across organizations and markets. There are no anomalies between front and back office and no shelters to hide inappropriate activity or fraudulent trades.

As managing risk is no longer confined to the trading desk, it's not just about managing price risk or market risk any more. It's important to recognize that a mandate infringement or a breach of regulations, however minor it may appear, is part of a much wider issue. Corporate governance is the story now, and it requires complete transparency across the enterprise and at all levels. That means that any system used to manage operational risk should provide a complete reporting function that can turn data into actionable information.

The good news is that enterprise-wide risk management can be turned to an organization's advantage. The potential benefits are big: from the positive returns, lower cost of capital, and stabilized earnings to new profit opportunities. But if that's not convincing enough then a quick glance at Paris tells its own story. Bluntly put, effective risk management is what keeps you in business.

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