

Editor's Note

The evolution of a risk manager

As we wrapped up work on the second issue of Pakistan Risk Review, I sat down and took a few minutes to look back at my relationship with risk over the last decade.

Belief in models – the first five years

When I first read John C Hull's definitive text on derivative pricing in 1995, the models in the book were nothing short of inspiring for anyone who has been moved by them. I found something to build in Excel which was not a prototype, not a business plan, not a financial statement but the price of a financial security misunderstood by a large number of my peers. The figure on the white monitor screen was absolute and final, questioning it was blasphemy. Such graceful and elegant models couldn't possibly be wrong.

Introduction to the generator and the many faces of Nassim Taleb – the next five years

Even though as actuaries we had covered generator functions as part of the risk curriculum it took Mark Broadie at Columbia University to actually show us what a generator meant and how it could be implemented within a few strokes in Excel. A year before on an engagement at Goldman Sachs I had come across the great debate on models and the role of generators between Nassim Taleb and Philip Jorion and the Broadie course further reinforced what Nassim had emphasized. A model was only as good as its implementation and assumptions. In most cases it was an inaccurate approximation; in others it was completely wrong.

But then Nassim over the years also showed how you could exploit the same imperfect models as a trader, a teacher, a writer, and a cynic. This imperfection is embedded within our markets and systems and as we evolve as professionals, rather than ignoring or distrusting it, we learn to play with it.

Brush with capital and the business side – the last five years

The Alchemy story marked the beginning of walking the line between traders, risk managers and Board of Directors. Once we added capital and Basel II to the mix, there was no going back to academic defences. Clients, Boards and Auditors asked tough questions and opinions leading to economic decisions with real impact that you couldn't qualify or disclaim. To survive it was necessary to extract an opinion from ambiguity and uncertainty. Our role was to help the business side understand the magnitude of the bets they make. And the easiest way to communicate and quantify this impact was to translate it into capital requirements.

Implementing concepts

All of this was still a long way off from the discipline required to convert our understanding of risk into practical, failsafe processes that shift into the right gears as risk profiles transition across economic cycles. More importantly the imperfection of models also raised questions about the usefulness of numbers publications similar to PRR presented. Was it better to have qualified analysis or no analysis at all? Would you rather travel blind or with an outline of a map that suddenly degenerates into a grossly inaccurate caricature if the risk landscape shifts? Did it help that you knew that this degeneration was possible? Why was it that the risk function worked better with some banks compared to others? Was it a failure of models or a failure of processes? In a world used to absolute, black and white answers, you had to educate customers on shades of grey.

The end state

It took a decade, possibly more of being exposed to risk, of losing scarce capital, of reading everything Nassim Taleb wrote, of teaching customers and students about the absence of absolutes in our field and walking the fine line between opinions, educated guesses, missteps and wild shots in the dark to get where I am today as a risk professional. When it comes to risk the right position is neither as a believer, nor as a cynic; or an agnostic or a zealot for that matter. It is somewhere in between.