

Editor's Note

Good data, models, instincts and statistics

Risk and transaction systems differ in many ways. But they both suffer from a common ailment - Good data and working models. On a risk platform the integrity of the data set is dependent on the underlying transaction platform and the quality of data feeds. Keeping the incoming stream of information clean and ensuring that the historical data set remains pure is a full time job. The resources allocated to this problem show how committed and reliant an organization is to its risk systems.

In organizations still ruled by the compliance driven check list mindset, you will find that it is sufficient to simply generate risk reports. It is sufficient because no one really looks at the results and when they do in most cases they may not have any idea about how to interpret them. Or even worse, work with the numbers to understand the challenges they represent for that organization's future.

The same problem haunts the modelling domain. It is not sufficient to have a model in place. It is just as important to understand how it works and how it will fail. But once again as long as a model exists and as long as it produces something on a periodic basis, most Boards in the region feel they have done the necessary ground work / met the minimum requirement for risk management.

Is there anything that we as risk professionals / risk practitioners can do to change this mindset and fix this problem?

One could start with the confusion at the Board level between Risk and the underlying transaction. A market risk platform is a very different animal from the underlying treasury transaction. The common ground however is the pricing model and market behaviour, the uncommon factor is the trader's instinct and his gut. Risk and the transaction systems clash on this uncommon ground. Instincts versus statistics!

The instinct and gut effect is far more prominent on the credit side. Relationships and strategic imperatives drive the credit business. Analytics and models drive the credit risk side. The credit business is "name" based, dominated by subjective factors that assess relationship, one at a time. There is some weight assigned to sector exposure and concentration limits at the portfolio level but the primary "lend", "no lend" call is still relationship based. The credit risk side on the other hand is scoring, behaviour and portfolio based. A payment delay is a payment delay, a default is a default. While the softer side can protect the underlying relationship and possibly increase the chances of recovery and help attain "current" status more quickly, the job of a risk system is to document and highlight exceptions and project their impact on the portfolio. A risk system focuses on the trend. While it is interested in the cause of the underlying event, the interest is purely mathematical; there is no human side.

I asked earlier if there is anything we can do to change. To begin with, Boards need to spend more time and allocate more resources to the risk debate. Data, models and reports are not enough. They need to be poked, challenged, stressed, understood, grown and invested in. Two hours once a quarter for a Board Risk Committee meeting is not sufficient time to dissect the effectiveness of your risk function. You may as well close your eyes and ignore it.

But before you do that remember hell hath no fury like a risk scorned.