FOCUS ON

RISK MANAGEMENT

Tony Glickman of Northern Trust takes a look at the risk management trends from the past year and what we can expect to emerge in 2014

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As we approach the end of 2013, it is time to step back from the critical but often tedious tasks of model vetting, database management, and form filing that occupy so much of a risk manager's time and focus on the broad landscape in 2014. From the vantage point at which we sit, at the intersection of trillions of dollars of hedge fund, pension fund, and other investment assets, four major trends in risk management appear to dominate.

First, asset managers are adjusting to the notion that we are at the beginning of regulation and not the end. Form PF, the AIFMD and CPO-PQR are all essentially risk reports. While these initial steps taken to regulate asset owners and asset managers have been awkward at times (and even heavy-handed), regulators are finding their way. Much of the uncertainty facing asset owners at the beginning of 2013 has been dispatched. In the US, we now have a far better understanding of Form PF and the experience of a few reporting cycles to refine operations. The fog around the definition of 'Regulatory Assets under Management' has cleared along with definitions of liquidity, unencumbered cash, and other items that initially confused the market. Europe is following a step behind and is slowly moving along the same path toward clarity of the AIFMD. Although the long days and nights that accompany initial filings have yet to be experienced in Europe, the path forward is clearer. Many European fund managers and investors have kept a close eye on Form PF filers and understand the trajectory of compliance with a new directive.

Regulation is only at the beginning, though. The events of 2008 and its aftermath were too unsettling

to be addressed with these first regulatory measures alone. At the least, we should expect to see other jurisdictions follow the US and European regulators with filing requirements of their own. As ever, filers should remain focused on a key principle: regulatory filings need to be consistent across jurisdictions and with all communications to investors. At the same time, it would be good if regulators were also mindful of the need for consistency across jurisdictions. The go-it-alone approach forces filers to duplicate work needlessly, increasing operational risk and compliance expense.

Ironically, seemingly comprehensive regulations have the potential for deleterious effects. In addition to the prodigious cost of preparing these filings, the objective definition of filing responsibilities can potentially turn risk management and compliance into a 'tick-the-box' activity. Regulatory compliance should be viewed as a minimum standard. Filing Form PF and all the other paperwork required of risk management does not encapsulate the risk manager's responsibility to provide thoughtful and effective oversight of the firm's exposures. Proactive advisory to portfolio managers, senior management and investors is not the same

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as passive compliance with the demands of regulators, however comprehensive they may seem.

Second, traditional asset managers, whose risk analytics have been largely confined to benchmarking, are learning that their risks are not completely served by the well-established risk technology prevalent in the long-only space. They are only now beginning to learn that their risks are not linear and that they need risk tools developed by the sell side. Multi-factor linear models do not work for dynamic strategies where risk factor exposures change more frequently than in the past. Furthermore, as traditional asset managers incorporate derivatives with optionality into their portfolios, they will learn that such models need, at the least, to be supplemented by newer technology if not replaced entirely.

Third, in a world where outsized moves occur with alarming frequency, risk managers are learning the importance of stress testing and scenario analysis to complement Value-at-Risk (VaR). Basel and Form PF breathed new life into VaR at a time when the words "Black Swan" entered the popular vocabulary thanks to the unlikely confluence of Nassim Taleb and Natalie Portman (Taleb for his book and theory on hard-to-predict, rare events; and Portman for starring in a psychological thriller by the same name.) VaR is the single most popular measure but risk factor stress tests and scenario analysis are the new heart of risk management.

Finally, everyone is beginning to realise that the greatest risk of all is liquidity. We will see many new developments in liquidity risk management over the quarters ahead. Some of the best risk minds in the business are focused on moving past simple mappings of securities to trading volume. Liquidity risk is the next big thing in risk management and will join the trends above as major focal points in 2014. ■