

TRIPLE TROUBLE

The credit crunch in the markets this summer and fall was a sharp reminder that, in banking, trouble rarely comes alone.

When the extent of potential losses in subprime lending emerged last spring, it first looked like the damage would be contained to specialist banks in the US exposed to borrowers with poor credit histories. But by late summer, a wave of volatility swept across the global financial markets as it became clear that many financial institutions around the world would suffer losses from investments linked to US subprime.

This led to a global reassessment of the credit and liquidity risks incurred in asset-backed markets and the returns investors expected for assuming those risks - a reassessment with immediate consequences for banking.

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The most obvious consequences were the drying-up of leveraged lending to buy-outs, a curtailment of prime brokerage credit to hedge funds, and a steep rise in the cost of default protection in the credit derivative markets. Meanwhile, banks that depended on funding through securitization into the secondary market faced a short-term liquidity crisis - and the growing realization that business models overly dependent on this source of cheaper funding might not be viable in certain market circumstances.

The apparent underlying health of the global economy has helped stave off disaster, at least for a while. But an uncomfortable truth remains: a problem that started in a US specialist banking sector suddenly threatened the fortunes of other financial intermediaries, including

hedge funds, regional commercial banks and global investment banks.

So far, much of the industry comment has focused on the most obvious trigger - poor underwriting standards in the subprime sector. But there are other observations to be made from an enterprise risk management perspective:

SUBPRIME LENDERS FAILED TO LOOK AT RISK INTERACTIONS IN THEIR BUSINESS MODEL

It's tempting to blame the subprime crisis on poor underwriting alone. But the real problem was that many lenders failed to quantify the risks attached to a combination of:

- a) targeting customers with poor credit histories;
- b) offering product structures (interest only and negative amortizing loans) unsuited to subprime; and
- c) foreseeable macroeconomic shifts.

Maintaining volumes and compensation for expected losses became the driving force in the sector, even though the real threat and risk costs arose from the potential for unexpected levels of loss arising from the combination of risk factors built into the subprime business model.

CREDIT RISK MANAGEMENT FAILURES CREATE FUNDING AND LIQUIDITY RISKS

Banks prefer to consider risk types and risk-taking activities one at a time, as this is often how they are managed and reported by line-level risk functions. But the summer crisis underlined the way that credit risk scares lead to funding and liquidity risks, then market risks, and then business volume risks. Investors also suddenly became conscious of the

potential links between different bank activities, driven by similar underlying collateral type (eg, house prices). Then they began worrying that laxity in bank risk management might have spread across a number of banking sectors. In effect, spooked investors suddenly started thinking in the kind of 'integrated' or 'enterprise-wide' risk management terms that can sound overly theoretical to bankers in more normal times.

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SHARP LOSS OF BUSINESS VOLUME IS A RISK, TOO

A particularly striking feature of the crisis was how quickly the liquidity crunch hit business volumes for certain kinds of banking institutions. This was most readily apparent for investment banks that depended on a fast-moving flow of heavily leveraged deals. But a little way down the line, commercial lending also looked vulnerable because higher credit spreads - while attractive from a risk management perspective - depress lending volumes.

Banks need to better understand how business volumes in their various activities are related, and the way in which their operating leverage (ratio of fixed versus variable costs) can turn volume volatility into economic loss.

Banks must work harder throughout the economic cycle to measure and manage risk combinations and enterprise-level risks. That way, they won't have to play an uncomfortable game of catch-up with investors during a moment of market drama. They will also be able to mend processes and manage risk concentrations ahead of investor risk perceptions, while risk transfer is cheap.

For well-managed banks, the recent crisis may yet prove a useful dress rehearsal for when the underlying strength of the global economy begins to fade.

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