Challenges in Practice

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Risk Management of "Teams"

- How to measure individuals' risks, structure their incentives, and determine the capital and liquidity requirements, when there are multiple sources of correlated risk in a firm?
- If, for example, within a bank, one trader's position partly offsets (or augments) the risks taken in another trader's position, how should the firm's practices in **risk measurement, capital and liquidity budgeting, and remuneration**, take account of that in a way that optimally rewards performance, while minimizing the costs to the overall firm of controlling risk?

Hedging Risks

- Hedging creates risk, along with reducing risk.
- Basis risk is part of that story. Liquidity risk may be more important, and harder to measure.
- Hedging a present value of a risk is not the same as hedging a cash flow, and some of the cash flow issues that arise in hedging are unpredictable, since they depend not only on the possibility of loss or gain, but on the **time-varying market liquidity of the assets whose returns are being hedged,** since loss in the hedge might create the **need to fund the hedge through a sale of assets**.
- Is this a serious concern? How can one model and control such time-varying liquidity risks?

Incentivizing Information Flows

- How to facilitate communication especially about Rumsfeld's "unknown unknowns“ (risks not fully understood by CROs)?
- People often focus on what they can measure, on risks that have been modeled.
- Risk managers may lack crucial knowledge about newer or harder-to-model risks, and they depend on information about risk that is communicated to them from the people operating at the frontier of taking those risks.
- How can those people be encouraged to share information, not just about the risks they have an opinion about, but also about the aspects of risk that they are uncertain about?

Fundamentally Flawed Measures of Risk?

- One prominent CRO of a global bank recently told me that the measures of risk he keeps for purposes of satisfying his regulators and supervisors are useless for actually managing the risks of the bank.
- According to the formulas he submitted to the regulators, 80% of his risk was credit risk, 13% was market risk, and 7% was operational risk. In fact, he said, more than 60% of his risk was market risk.
- Are regulatory measures of risk, say, under Basel II, conceptually flawed, and if so, how could they be improved?