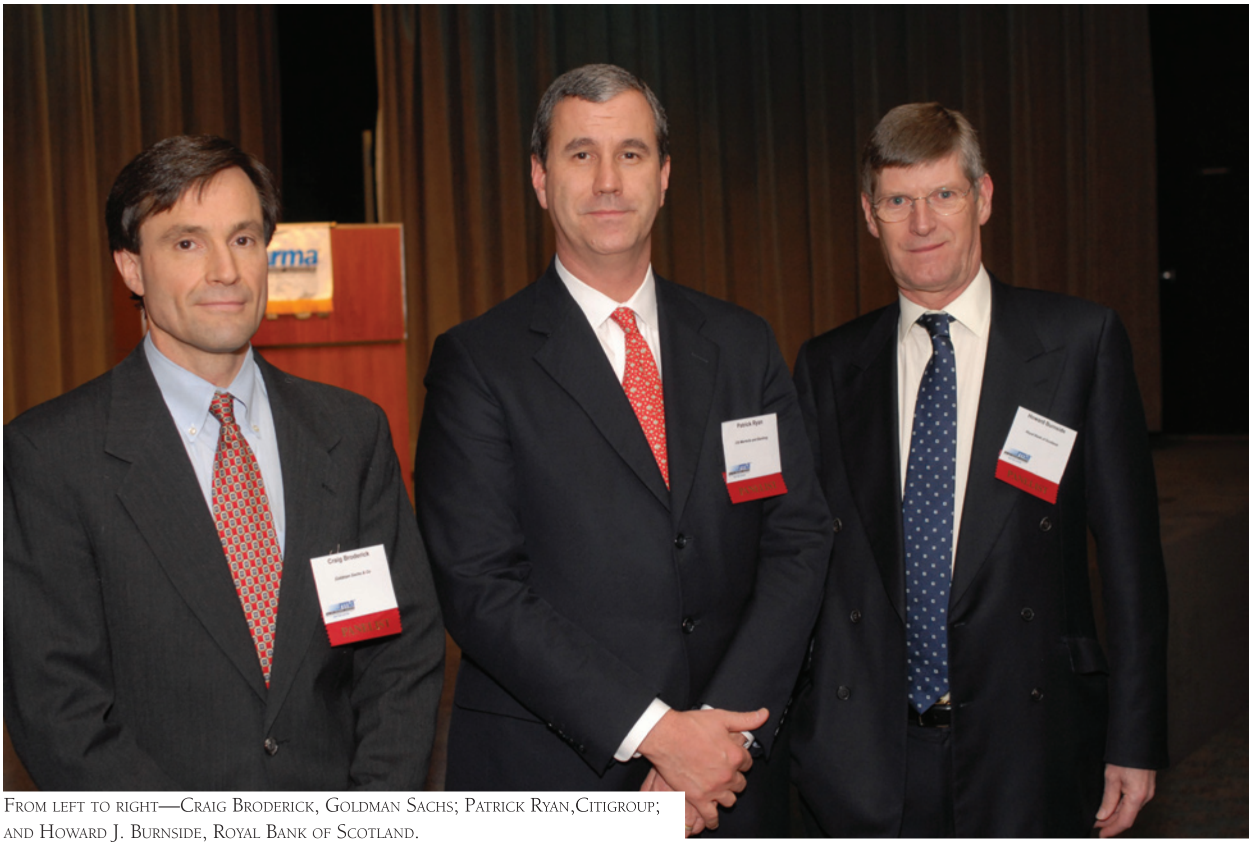


From left to right—Craig Broderick, Goldman Sachs; Patrick Ryan,Citigroup; and Howard J. Burnside, Royal Bank of Scotland.

# Fear & Greed:
## The Bookends of Capitalism
*Lessons Learned from the Current Crisis*

The annual Chief Risk Officers' Round Table held by RMA's New York Chapter each January was a sold-out event this year. No one has escaped the extreme turmoil that has roiled the markets since early August, and everyone is eager to gain insight as events continue to unfold.

Chapter President *Shaheryar Azhar* moderated the distinguished panel that included Citigroup Markets and Banking CCO and Co-Head of Risk Management *Patrick Ryan*, Royal Bank of Scotland CRO *Howard J. Burnside*, and Goldman Sachs CRO *Craig Broderick*. Introducing the panel, Azhar noted that "capitalism is book-ended between periods of greed and fear, and we may be living in one of those periods."

It is clear now that the former was all too prevalent just a year ago and that the latter is in total control today. Noting that 2007 was an epic year in risk management, Citigroup's Ryan said, "The state of the leveraged loan market

Photos by William Thomas Cain

right now is as bad as I've ever seen." While markets remain under intense pressure, it is not too soon to begin to look at some of the lessons learned to date. Ryan said that economic and risk capital frameworks can break down in a stressed environment. It is important that multiple measurements of risk be used to dimension your risk profile, hedging strategies, liquidity, and capital requirements. Also, it's essential that all risks be aggregated at a firm-wide level and that stress testing be applied at an aggregate level. "Aggregation of risk and stress testing must go hand-in-hand," Ryan said.

Ryan also noted that in many cases "underlying asset and collateral values matter more than structure," and he suggested, "If you can't sell the whole CDO structure, maybe it wasn't really viable to begin with, or it certainly wasn't as profitable as it appeared." Discussing the myriad of complex instruments used to mitigate risk, he stressed, "Macro hedging can occur at the business-line level, but must also be conducted at a firm-wide level."

Over the past decade, the industry has invested heavily in risk management systems and complex capital allocation frameworks, but Ryan suggested that "all of the right ingredients, facts, scenarios, checks and balances may separately not be enough. Risk management has to be integrated throughout the firm to reach the best judgments and actions."

Royal Bank of Scotland's Burnside noted that in Europe the state of the leveraged markets was not as severe as in the U.S. "Covenant light did not make it into the European market." There has been a disruption, no doubt, "but not a complete freeze," he said. Lessons learned? Liquidity cannot be taken for granted. Burnside suggested that, going forward, the industry will need to understand "how to transfer the price of liquidity to the line of business." He recommended that a premium be charged for business lines that rely on external funding. "We need better pricing for term in transfer pricing," he stressed, "particularly when there is no penalty for using the firm's liquidity."

The industry must take more responsibility for transparency and clarity in its public reporting if it is to restore confidence, Burnside believes. "The system will self-correct after it overcomes the collective indigestion of its unsold backlog. But we have to recognise this process may well take a good part of 2008" he stressed.

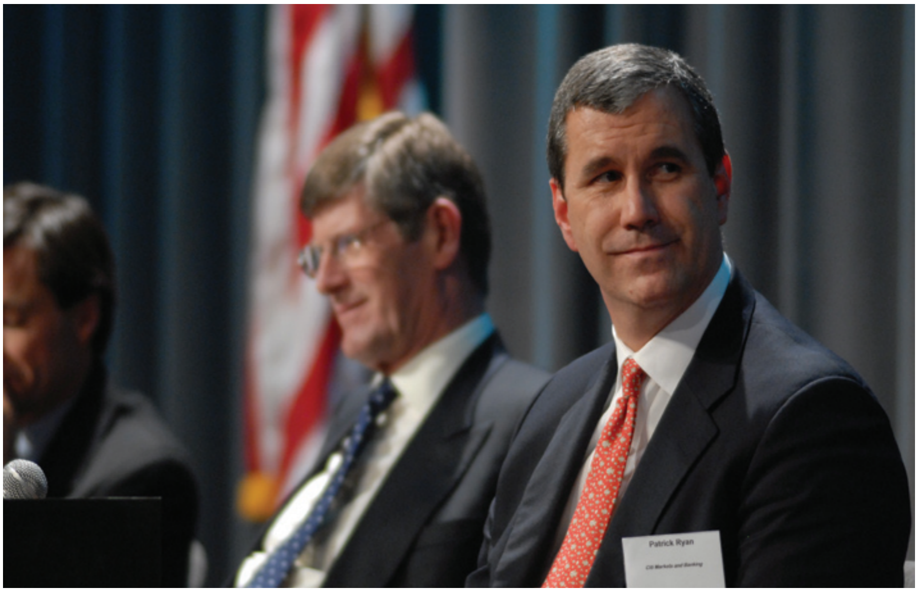
Like Ryan, Burnside believes that success is determined by "how risk management operates within the firm on a firm-wide basis." Risk management must be embedded at the executive level to ensure that the important issues are addressed.

Goldman Sachs' Broderick highlighted the disruption caused by a relatively small number of quantitative strategy funds that in mid-August hit their trip wires and began to unwind positions. "We had absolutely astounding moves among a small number of equities, moves that defied normal statistical probabilities, and suddenly some funds were down more than 25%." While noting the situation did self-correct eventually, he said, "It served as an effective reminder of two very important fundamentals: 1) the risk posed by crowded trades, and 2) the lack of visibility that crowded trades produce and the difficulty in identifying where the risk resides."

Moreover, the combination of events since August underscores "how unforgiving the markets can be, how correlated and opaque positions can be, and how frequently we can see market moves that exceed normal confidence levels," Broderick said. In terms of "lessons learned," Broderick pointed to "rigorous marking to market positions to where they can be sold, not where you think they theoretically should be

New York Chapter board member Rae Etherington, executive director, Hedge Fund Credit, ABN AMRO Bank, at the sold-out event in January.

valued. Without good marks, you won't know what your positions are, no matter how good your risk metrics."



Broderick also praised the effectiveness of basic stress tests as a risk management practice. "Stress tests that are run for positions across the whole firm, across all counterparties, and across all market trends can reveal significant big-picture issues that can sometimes get lost when looking at more refined metrics," he said. The independence of risk management personnel is also critical, he said, adding that the risk and control functions at Goldman Sachs report to the firm's CFO. He also stressed the importance of sound business judgment. "Being disciplined and having effective risk management controls are critically important, but the ultimate litmus test should be fundamental business judgment."

All three expect market conditions to remain weak throughout the year; the problem moved far beyond subprime mortgages. Credit spreads clearly indicate that default rates will head upward. Now, more than ever before in recent times, the importance of effective, integrated, firm-wide risk management is clearly needed to manage through these extremely challenging markets. ❖