

Lessons from the Current Financial Crisis

David X. Li



中国国际金融有限公司
CHINA INTERNATIONAL CAPITAL
CORPORATION LIMITED

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To think about unthinkable

- Risk management needs to adopt a “doctrine of no surprises” and to think about unthinkables and to challenge the common or traditional “wisdom”.

Examples:

- ABS securities do not default.
- The house price will never go down.
- The government does not allow a large financial institution to fail.
- Wall Street firms have the best risk management practice.
- Super senior tranches are safer than AAA and will never incur \$1 dollar loss
- We can always borrow money at a low rate.

Risk Management is about effective communication

- Risk management processes are designed to ensure senior management has the right and prompt information required to make decision.
- UBS has the best mortgage research team, but it incurs one of the most mortgage loss among Wall Street firms.
- Citigroup's Board of Director Chairman Robert Rubin claimed that he had never heard about "EOD" triggers and liquidity puts while Citigroup had been ranked #1 in cash CDOs, many of them have these features.

Risk Management needs to be pre-active and prudent

- We do not need a passive risk management: Most of the time we do not need a passive risk management. During crisis or extreme cases risk management is caught in a surprise as the rest of the organization.
- Effectively managing the risk associated with a new business development is a critical and intrinsic responsibility of risk management.
- Risk management is not only about VaR calculation, neither various risk reporting.
- We cannot take a bet which can bring down our franchise, neither take a franchise reputation risk simply to pursue some profit.

Risk Management is about understanding

- Risk Management needs to have a full understanding of all products, businesses of the firm and various risk methodologies and their limitation.
 - ABS CDOs are not CDOs, they are more like CDO².
 - We need both prepayment and default curves to study the sub-prime problems
 - ABS bonds have an extremely high correlation, which makes senior tranches of ABS CDO very risky.
 - Moody's binomial expansion method does not capture the fat tail of loss distribution. It approximates any loss distribution by a three point discrete distribution.
 - SIV is rated by rating agencies with a model which essentially assumes no correlation among the underlying collateral assets.

Risk Management is about an integrated approach to information

- We need to establish an integrated system to quickly gather, process various information to help us make right decision quickly.
 - We spend more time to gather information than to do analysis.
 - We do not have formal system, so we use Excel to value securities by ourselves.
 - We cannot integrate market risk and credit risk.
 - We have to run an P&L based on the position of yesterday.
 - Effective risk management requires an integrated approach that spans all of the risks to which the firm is exposed – including business risks. Segmented, partial approaches are less effective.

Risk Management is about people

- The largest risk is the risk created by human beings!
 - Culture is very important: traders can not overrun the whole organization.
 - We need to understand the incentives and align individual interest with the firm's interest.
 - Common sense is often paramount.
 - We need more experienced risk managers.
 - Every derivative is a zero-sum game.
 - We need to take a game approach toward each transaction.