Global news, opinion, strategies and data
structuredcreditinvestor

News 20/08/08

Seeking sophistication

New risk management techniques on the rise

As the bulk of structured finance assets move from off-balance sheet structures onto bank balance sheets, concerns have emerged over the lack of infrastructure in place to deal with systematic risk and consequent risk monitoring. While regulatory and policy bodies are united in their call for enhancements in this area, a number of large organisations are said to be already adopting more sophisticated portfolio risk management techniques.

These techniques will become all the more important not only as banks resign themselves to holding debt to maturity, but also as opportunities to invest in distressed assets increase. "The structured credit market has a great deal of good buying opportunities on offer, given where asset prices are at the moment. But investors will not be given mandates to invest in this area unless they have the appropriate controls and sophisticated risk management techniques in place," says Douglas Long, evp business strategy for Principia Partners.

Given that SIVs and conduits – which had significant inherent risk controls imposed on them by the rating agencies – are no longer investing in structured credit, the majority of assets are being bought by on-balance sheet investors, which have traditionally relied on credit ratings rather than having bespoke risk management systems in place. "We are now seeing a significant change in approach for these on-balance sheet exposures, as organisations move towards more sophisticated portfolio management techniques – meaning they will have a single system and infrastructure in place to manage the assets and monitor risk appropriately," Long confirms.

He adds that both off-balance sheet and on-balance sheet investments will need ongoing surveillance and reporting of exposures to convey how assets are performing on a timely basis. "Data providers are reinforcing standardisation in the market and they are fostering the correct environment, which is the first step to recovery."

Earlier this month the Counterparty Risk Management Policy Group III released a report entitled 'Containing Systemic Risk: The Road to Reform'. Key points covered in the report include recommendations for significant enhancements to risk monitoring and management, as well as a reconsideration of the standards for consolidation under US GAAP of entities currently off-balance sheet coming on-balance sheet and measures to better understand and manage high-risk financial instruments (see News Round-up for more).

For the time being, however, counterparty risk remains a key issue for the market, particularly in relation to CDS. A recent survey issued by Greenwich Associates shows that 85% of US institutions see CDS counterparty risk as a serious threat to global markets, and just more than 55% of institutions in Europe see CDS counterparty risk as a significant danger. The survey also shows that more than 90% of hedge funds see counterparty risk relative to CDS as posing a significant threat to global markets (see News Round-up).

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