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RPT-INSIGHT-Wall St risk management: better, but hardly fixed

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(Repeats INSIGHT released late on Wednesday)

* Firms have sorted out risk management governance issues

* But technological issues and modeling problems persist

* Getting banks to where they need to be could take years

By Dan Wilchins

NEW YORK, June 30 (Reuters) - With fear and loathing returning to world markets, risk managers are facing their biggest test since the financial crisis.

In the run up to the 2008 financial crisis, risk managers' warning were largely ignored.

Since 2009, many banks have been working overtime to get their house in order and better manage trading operations.

Lawmakers and regulators are goading banks to keep at it. U.S. Democrats are trying to get a sweeping new law through Congress that targets some of the industry's risky practices. Worldwide, regulators see an improvement in banks' own risk management as a key piece of the puzzle, as noted in the final statement from the recent G-20 meeting in Toronto.

But while banks and governments have been focused on improving the situation and have made some limited progress, there are still numerous problems with risk management on Wall Street. That starts with a lack of tools to quantify their risks, or even to identify all of the details about the positions on their books.

"There's still a long way to go to make up for some of these gaps," said Sid Sankaran, a risk management consultant who works with major banks at Oliver Wyman. "It could be a multiyear effort."

Griped one senior trader at a major firm: "Risk management has not evolved in any meaningful way since the crisis."

Financial institutions globally have taken more than $1 trillion of losses and writedowns since the credit crunch began in 2007. They are ill-equipped to sustain more blows.

But with global stock markets again swooning, many investors fear trading losses are possible. Risk management is crucial for ensuring that tempestuous markets cut into profits, but do not trigger losses big enough to hobble the firm.

Banks have improved some elements of their risk management efforts. Morgan Stanley (MS.N: Quote, Profile, Research, Stock Buzz), for example, is on track to double the number of risk managers on staff from 2008 levels.

Banks are spending more on risk management technology -- consulting firm Tower Group estimates financial firms globally will spend $8.7 billion on risk and compliance systems in 2010, up 82 percent from 2008.

And many banks have made organizational changes, including changing reporting lines for risk managers, making it harder for traders and business managers to overrule them.

Financial institutions have broadly reduced the amount of risk traders are entitled to take and made it more difficult to get exceptions to those limits. Traders report having more conversations with risk managers and those conversations tend to be longer now.

Still, some things have not changed. Just about every firm on Wall Street still uses a measure known as value at risk or VaR to quantify possible losses. Managers and traders are ambivalent about the measure, because it quantifies the highest possible losses the firm could sustain on most trading days, which can be a useful summary of risk.

But on exceptionally bad trading days, losses can be many times worse than VaR forecasts, so the measure can create a false sense of security.

"There are definitely valid criticisms of VaR. It has its limitations," said one chief risk officer at a major dealer.

"But any model has limitations," the CRO added.

Risk managers are getting paid more, but they are still not as high profile as bankers, senior traders and others who generate revenue for the firm. Most major banks are reluctant to allow their risk managers to speak on the record.

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Graphic on risk management

systems spending link.reuters.com/jeb25m

Risk managers getting paid more [ID:nN30248251]

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MIND THE GAPS

Firms are still not great at measuring their overall risks, in part because they usually lack the technological infrastructure to record information about all of their positions, said Chris Donohue, director of research for the Global Association of Risk Professionals.

"There are many risks in the gaps between different parts of the bank," Donohue said.

For example, a bank's residential mortgage bond trading system might not include information about the geographical distribution of loans that are packaged into a particular mortgage bond, let alone its entire portfolio of mortgage securities.

The bank's commercial mortgage bond trading system may also lack that information. And the bond trading systems likely do not have a link to the bank's loan trading desks, or loan making business. So a bank looking to find its total exposure to home loans in a particular region will often have no easy way to get the job done.

Adding to these difficulties, a number of major dealers were built through acquisitions over several decades, meaning there are myriad trading, loan and risk management systems to be harmonized, said Oliver Wyman's Sankaran.

Beyond shortcomings in systems, firms often do not have the intellectual framework in place to fully understand how their trading books and other assets will perform during difficult periods, said Campbell Harvey, a finance professor focusing on risk management at Duke University's Fuqua School of Business.

A poor understanding of risks can lead a firm to melt down, but it can also lead a firm to refrain from taking more risk when opportunities are good. For banks, that can lead to their not lending enough during the trough of the cycle, when lending could be profitable and provide the biggest boon to the economy.

"Getting this right is important," Harvey said.

GEESE AND THE GOLDEN EGGS

Skimping on risk management has historically been an easy way to reduce expenses in an area whose contribution to the bottom line is hard to measure until the firm blows up.

One former senior executive for a major bank observed that banks decide late in the year how much money to spend on risk management systems for the following year.

Those budgeted funds are fixed and are not usually increased, even if new rules and regulations emerge that require immediate spending on information technology. The upshot is, firms can delay making investments they know are necessary over the long term, because they are spending too much on pressing technological issues.

Another senior executive pointed out that, when markets improve and particular business lines begin making a good deal of money, managers often become reluctant to rein in risk taking.

"When nobody's making much money, it's easy to be tough on traders. When they've been making most of the firm's money for years, it's much harder to be punitive, he said.

Duke's Harvey agrees, noting: "The further we move away from the financial crisis, the lower the priority for risk management."

Harvey estimates banks could need five years of concerted effort to really bring their risk management systems and processes to where they ought to be. (Reporting by Dan Wilchins; editing by Andre Grenon)
