ADVANCED TRADING

After MF Global, Risk Management Again Takes Center Stage

In a familiar story, a major Wall Street firm flames out and others scramble to shore up their risk practices and systems.

The dramatic collapse of MF Global, the broker-dealer and clearing firm that was bankrupted by bad bets on European bonds, has sent financial services firms scurrying to make sure their risk management operations are up to the task, industry sources say. Even as much of Wall Street remains mired in a period of intense risk aversion in light of the European debt crisis and fragile U.S. economy, the demise of Jon Corzine's company has most of the industry on red alert. Experts say the current risk management environment is a flashback to the period immediately following the collapse of Lehman Brothers in 2008, when the investment community realized how costly it can be to not fully understand counterparty risks.

In the halcyon days prior to the 2008 global market crash, investment managers deployed risk management tools mostly to analyze the risks to which their portfolios were exposed, according to Phil Niles, the director of product development at Butterfield Fulcrum, an administrator for alternative investment firms. Such analysis gave firms a snapshot of how their assets stood in relation to each other, he notes, but it did not provide a clear picture of whether a counterparty could fulfill a contractual obligation such as extending or paying back credit. Now, three and a half years after Lehman Brothers, companies again are taking a closer look at counterparty risk.

"Lehman was many times the size of MF Global, so the reverberations were far greater," Niles says. "But MF Global definitely has shined the light back on counterparty risk. More than ever, though, the spotlight is being cast not just by investment managers, but by investors."

Investors Fear Counterparty Risk

Niles contends that clients are demanding answers from their money managers regarding their counterparty risk strategies, with a large number of investors requesting that trades be executed through multiple prime brokers as a means to keep risks in check. "These investors are coming from the standpoint of the illiquidity they faced toward the end of 2008," Niles explains. "They don't want a repeat of that and don't want to be invested in a fund that's going to be locked into a prime broker."

Experts agree that investment managers that choose to execute through a single prime broker are taking a huge gamble, because if that broker goes down, their clients' assets could be frozen or even lost forever. By trading through multiple prime brokers, fund managers can hedge that risk. And if they happen to trade across multiple asset classes, they can seek out brokers that specialize in particular instruments.

As another safety net against counterparty risk, some hedge funds and other money managers are executing through megabanks such as JPMorgan, whose hefty balance sheet and strong governance make it seem like a safe bet, according to Nicholas Dunbar, the author of "The Devil's Derivatives: The Untold Story of the Slick Traders and Hapless Regulators Who Almost Blew Up Wall Street ... And Are Ready to Do It Again." "They all often use prime brokers, particularly if they want to get leverage, short stocks or they want to get funding for transactions," Dunbar asserts. "They'll probably be increasingly going to the 'too big to fail' banks."

By design, traditional broker-dealers don't assume much risk, as they don't take overnight positions and are only exposed during the period in which they warehouse a position in order to match the two sides of a trade. They also take on only modest risk when making markets or underwriting securities. But Dunbar suggests things can get hairy for investors when their broker-dealers make their own wagers on the market through proprietary trading, as was the case with MF Global.

As an additional layer of protection, however, investment managers can buy a simple credit default swap on a particular prime brokerage, Niles points out. And though the practice is among the more expensive and risky options, it has grown in popularity lately, he adds.

"Some investment managers may choose to purchase protection through the form of a CDS contract on prime brokerages," Niles says. "The irony of ironies is that by undertaking the CDS contract, you are undertaking a newer counterparty risk because there is a counterparty to that CDS."

Meanwhile, Dunbar argues that Corzine's stricken firm is a symptom of a larger problem on Wall Street. In recent years, Dunbar says, a culture has arisen in many broker-dealers and trading firms in which the possibility of staggering losses is ignored in favor of the potential for enormous gains.

Putting Everything On the Line

"Most of us hate to lose. We don't like uncertainty; we try to avoid it, and we avoid bets with a big downside compared to upside. That characterizes most companies, like pension funds and insurers," Dunbar insists. "But inside trading firms, you need to have confidence about taking risks. They're willing to put everything into a bet that can give a good payoff. Jon Corzine typifies that culture."

George Michaels, the founder of tax compliance software provider G2 FinTech, argues that while banks need to measure their exposures, neither investors nor their money managers really care all that much about risk management. "Measuring risks never makes you money; it just costs money," says Michaels, a former Goldman Sachs VP. "Every investor always wants one thing: returns. Do they want risk management? No -- because they always forget the same basic rule: that past performance is no indication of future results."