RISK MANAGEMENT IN VOLATILE FINANCIAL MARKETS

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RISK MANAGEMENT IN VOLATILE FINANCIAL MARKETS

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Editors' Introduction*

A spate of financial market shocks, including market crashes and institutional failures, have focused minds on the question of *risk* in the innovative, globalising marketplace of the 1990s. This volume examines the topic of risk management in volatile financial markets from three different perspectives: from a first perspective of market participants managing risk; from a second perspective of regulators and central bankers endeavouring to ensure stability and growth; and from a third perspective of academics seeking to understand and clarify the underlying trends and implications. The seventeen papers, a mix of technical and more 'accessible' work, juxtaposing case studies with broader appraisals, are presented in five main parts.

Central Bank Perspectives

In Part A two papers provide a central banking perspective, emphasising the greater weight being placed upon the market to deal with risk, with market participants needing to enhance their risk-management capabilities. Dr Markus Lusser, head of Switzerland's central bank, stressing that 'volatility is here to stay', calls for market forces rather than regulation to be the basic control mechanism for risk-taking activities. Andrew Crockett of the Bank for International Settlements (BIS), the 'central bankers central bank', observes that some institutions have lacked the necessary information and skills to assess risk exposure and that in some dramatic cases, the incentive structure for individuals and institutions has encouraged greater risk-taking than desirable.

Volatility and Risk

The five papers in Part B examine market developments in volatility and risk. Martin Hellwig of the University of Basle and Harvard University sees the problem coming not from an increase in risks *per se* but from the pressures of

* This volume has been edited by SUERF vice-president Professor Franco Bruni of Bocconi University, Milan, by Donald E. Fair, former Economic Adviser of the Royal Bank of Scotland, and by SUERF council member Richard O'Brien, principal, Global Business Network and Former Chief Economist of American Express Bank.

intense competition on banks and other financial institutions, as a period of oligopoly ends: more rather than less innovation is needed to help share undiversifiable risks, with more attention to correlations between different risks. Charles Goodhart of the London School of Economics (LSE), while questioning the idea that volatility has increased, concludes that structural changes have made regulation more problematic and calls for improved information availability on derivatives transactions.

In a thirteen country case study of the bond market turbulence of 1994, Borio and McCauley of the BIS pin the primary causes of the market decline on the market's own dynamics rather than on variations in market participants' apprehensions about economic fundamentals. Colm Kearney of the University of Western Sydney, after a six country study of volatility in economic and financial variables, concludes that more international collaboration in managing financial volatility (other than in foreign exchange markets) is needed in Europe. Finally, Stokman and Vlaar of the Dutch central bank investigate the empirical evidence for the interaction between volatility and international transactions in real and financial assets for the Netherlands, concluding that such influence depends on the chosen volatility measure. The authors suggest that there are no strong arguments for international restrictions to reduce volatility.

INSTITUTIONAL ISSUES AND PRACTICES

The six papers in Part C focus on what market participants are doing to manage risk. The opening paper by Philip Davis of the European Monetary Institute (EMI) highlights the effect of the behaviour of institutional traders on recent periods of market instability, warning that with the institutionalisation of portfolios still in its infancy the impact of institutional trading will grow, necessitating more research into institutional behaviour and the behaviour of global capital flows.

In the first of two papers contributed by the marketplace Robert Gumerlock of Swiss Bank Corporation demonstrates how the risk implications of fluctuations in market rates can be measured and an internal control system designed to protect a bank. In the following paper, from the corporate sector, Ronner and Trappeniers discuss the currency exposure management techniques pursued at Philips.

Academia then provides three specific studies. Svend Jakobsen of the Aarhus School of Business focuses on measuring value-at-risk for mortgage backed securities using data from the Danish market. Caillet and Gallais-

Hamonno of the University of Orleans suggest that the market for warrants on the Paris stock exchange reveals evidence of possible systemic risk. Finally, Lewis and Morton of the University of Nottingham examine risk management within the context of the retail banking experience.

Policy Implications

The three papers in Part D broaden the focus to the policy implications, including the monetary policy perspective. Axel Weber's prize winning paper (*see The Prix Marjolin, below*) concludes that central bank intervention to try to stabilise exchange rates has had little lasting effect, either in the European context of the EMS or in the 'G3' context of the dollar-Deutschemark-yen rates. Alworth and Bhattacharya (of Mediolanum Consulenza and the LSE respectively) provide a wide-ranging examination of the regulatory framework and the effectiveness of recent measures such as capital adequacy rules. Finally in this section, a comparative study of monetary policy and market liberalisation in Poland, Russia and the UK, by Allen, Hoggarth and Price of the Bank of England, concludes that in Poland and Russia it would be better to identify monitoring ranges for monetary aggregates, rather than adhering to strict monetary targets.

The Marjolin Lecture

The concluding paper is the 1995 Marjolin Lecture by the Director General of the European Monetary Institute, Robert Raymond. The paper underlines the significant shift in recent years with respect to the roles and responsibilities of the 'authorities' and the market place, in order to cope with the trade off between price volatility and policy making, with central bankers now having to become media experts in dealing with the new relationship with markets, in stark contrast to their previous incarnation as 'silent gods'. In particular, policy makers now have to pay greater attention to 'the intrusion of time and space in monetary policy'.

Selection and Acknowledgements

The papers in this volume were selected by the Council of the Société Universitaire Européenne de Recherches Financières (SUERF) from the con-

tributions to the 19th SUERF Colloquium, held in Thun, Switzerland, in October 1995 under the chairmanship of SUERF President Jean-Paul Abraham. SUERF, founded in 1963, brings together more than twenty central banks, ninety private sector institutions and nearly three hundred individual members (particularly from academia). The Colloquia, held every eighteen months, focus on a key financial market topic in a plenary and workshop format.

The Council would like to extend its thanks to all the contributors and participants of the 19th Colloquium and especially to the SUERF council members in Switzerland, Aloys Schwietert of Swiss Bank Corporation and Joseph Bisignano of the Bank for International Settlements, to SUERF Council members Christian de Boissieu, Morten Balling, Martin Fase, Jürgen Pfister, Robert Raymond, Hans-Eckart Scharrer, and Jacques Sijben and Lianne Kieboom of the SUERF Secretariat, for their work in organising the meetings. SUERF also wishes to acknowledge the major financial support of the European Commission, the Bank for International Settlements and the Swiss National Bank and Swiss Bank Corporation who hosted the Colloquium at the SBC Training Centre in Thun. Additional support from Credit Suisse and Les Fils Dreyfus & Cie. was also gratefully received.

THE PRIX MARJOLIN

At the Colloquium SUERF was pleased to honour the memory of Robert Marjolin. A leading architect of post-war Europe, Robert Marjolin was the first head of the OECD, when set up as the OEEC to run the Marshall Plan, was the leading French negotiator of the Treaty of Rome, and then became Vice President of the European Commission, with responsibility for economic and financial affairs, for the first ten years of the Community. The Council of SUERF awarded the Prix Marjolin of ECU 2000 to Axel Weber of the University of Bonn and of the Centre for Economic Policy Research, for the best contribution to the Colloquium by an author of less than forty years of age. The award was presented by Robert Raymond who, as noted above, delivered the 1995 Marjolin Lecture at the Colloquium.

19 February 1996

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