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Financial Crisis is Opportunity

Ron Harasym

The rapidly expanding world of risk management just took another quantum leap in exposure and scrutiny as pain from the financial crisis blasted its way from Wall Street to household Main Street like a category 5 hurricane. In just the past few months, we have seen the collapse of large, long-established, seemingly strong and once well-respected companies. Given the rapid sequence of large-impact and hard-to-predict events beyond the realm of reasonable expectation, the financial crisis could very well be categorized as the latest entry to the "Black Swan" list. Some day, we will look back over the past few months and ponder with amazement how so few managed to get so many into such a devastating mess. A moment in history when the financial and economic landscape, while convulsing and contorting due to massive self-inflicted internal injuries, suddenly fractured and changed forever the way we look at risk.

Something just isn't right when (estimated) 1-in-10,000-year events suddenly become monthly, then weekly, then daily events. Consider your risk assessment if someone several years ago presented to you the following scenario (with multiple dependencies of course):

- Mortgage lenders abandon traditional prudent loan practices and make an extraordinarily high number of poor quality subprime loans;
- Mortgage lenders grossly over-leverage capital as these loans are packaged into securities, which in turn are sold to raise capital to support more imprudent lending;
- Downstream, risk exposure becomes heavily concentrated in government-sponsored mortgage entities and mortgage loan insurance companies;
- Securities sold by the government-sponsored mortgage entities are repackaged by various financial institutions into complex collateralized debt obligations (CDOs), structured in a manner that obscures the underlying risk;
- Investors, who don't fully understand these securities, flock to purchase these high-yielding securities that contain tranches of subprime loans;
- And finally the kicker—a change in macroeconomic conditions triggers a rapidly increasing number of subprime loans to become toxic with the ripple through impact of placing the whole house of cards in jeopardy of collapsing.

You sincerely might have answered that this scenario is too far beyond the realm of normal expectations to coherently comment upon. In such a scenario, policymakers and other

Ronald J. Harasym, FSA, CERA, FCIA, MAAA, is vice president and actuary at New York Life Insurance Co in New York, N.Y. He can be reached at *ronald_j_harasym@newyorklife.com*

participants would clearly be operating in uncharted and unknown territory. Perhaps you might reply that with so many unknown unknowns, an overwhelming and quick response is the only logical approach. And as such, quick and decisive action must be taken to control the hemorrhaging, break the dependencies and bring back a sense of financial confidence in order to avoid a complete financial meltdown. But only if it were so easy!

As companies and policymakers react to the fall-out of the financial crisis, one can only hope that risk management practices don't become Sarbanes-Oxleyied (for a lack of a better term). Risk management is not purely a mechanical exercise about minimizing or eliminating risk; it is about understanding risk and ensuring adequate compensation for risk undertaken. Leading up to the financial crisis, clearly there were widespread and unsupportable conceptual gaps in risk management walk versus talk.

The financial crisis and meltdown has split wide open an exceptional opportunity for actuaries to step up to the plate and establish themselves as the leading profession in the field of risk management. The basic training required to become an actuary provides a great foundation for a risk management role. We know how to gather and assess information. We know how to identify, categorize, quantify and qualify risk. We know how to define risk appetite and risk thresholds and how to develop risk responses and countermeasures. And most of all, our training instills in us not to jump to unfounded and unsound conclusions.

It is important to extract what lessons we can from the financial crisis. It is important to understand more about what happened, what risk management practices were in place, why these practices failed, and leverage our learnings to help anticipate and develop proactive responses to help manage the next emerging risk.

In my final remark as the outgoing Section Chair, I would like to thank all the Section Council members, friends of the Section Council and the SOA/CAS/CIA staff for their dedicated efforts over the past year. Kevin Dickson, Valentina Isakina and John Nigh will also be leaving the Section Council. I would also like to take this opportunity to pass the torch over to Don Mango, the incoming Section Chair, as well as to welcome our new Section Council members—John Manistre, Mike Stramaglia and Judy Wong. All in all, I had a "blast" over the past year working with everyone as the chair of the Joint Risk Management Section and look forward to continuing my involvement as a friend of the section. ✦

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