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Chairperson's Corner

Don Mango

I am looking forward to being Section Council chair during what promises to be another watershed year for risk management. By the way, how many of these years in a row can we stand? For my inaugural Chairperson's Corner column, I would like to review the credit crisis and ask whether opportunities exist for actuaries to play a larger role in risk across the board.

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I will begin with a staggering opening statement: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." This statement was made July 10, 2007 by Chuck Prince, then CEO of Citigroup. It summarizes what I believe to be a core lesson permeating risk management for all of financial services: we have met the enemy, and it is us.

Perhaps I was too limiting: our true enemies (in credit or insurance) continue to be greed, stupidity and fear. During the credit crisis, the greed was rampant as evidenced by the extreme leverage and almost total disregard for parameter estimation, stress testing or correlation; stupidity was most apparent in the incentive systems which remunerated producers on volume; and sadly, fear manifested itself in herding, panic and liquidity crises.

The Need for Financial Risk Professionals

The insurance industry as a whole has thus far weathered the crisis better than the banking and lending sectors. While there is still extensive forensic work ahead, there may be great opportunities for the actuarial profession to teach the capital markets about illiquidity and the value of a *financial risk profession*.

On the illiquidity front, it is safe to say the luster has worn off "mark-to-market." Many in the banking community are calling for a serious review of the process, claiming mark-to-market practices may have been pro-cyclical and exacerbated the crisis. Mark-to-market relies upon a liquid market filled with expert traders whose valuations are backed by their own positions—that is, the market valuations are granted credibility in part because serious players are betting their own money. However, when one seeks a market price in an illiquid market, this assumption breaks down. There are no traders willing to quote, no trades to observe, and no prices to discover. Under such conditions, what is one to do?

This liquidity breakdown troubled capital market financial risk professionals greatly. However, I will venture that most actuaries, if in the same position, would not have been as bothered, because our traditional roles are to provide valuations on portfolios of illiquid,

untraded, over-the-counter derivatives on unobservable underlyings (data on whether a car crashes or a person dies is not available on Bloomberg). Our approaches are principled, model-driven valuations—exactly what some critics of mark-to-market are calling for as an alternative when liquidity dries up.

Go a step further: credit risk analysis lacks a single professional body. Professions bring consistent basic education, licensing or certification examinations, standards of practice, continuing education and professional discipline. While we cannot dream to replace all credit analysts with actuaries, we can think about exporting our professional model to the credit world. There are many professional models the regulators could consider, but I suggest actuaries are the closest comparable. First, the "actuarial method" is one generally accepted approach in credit risk analysis. Second, actuaries know how to work with statistics and correlations, limited information and stochastic modeling. Third, as mentioned above, actuaries value illiquid portfolios and provide official opinions of those valuations that are then used for tax and regulatory purposes.

It seems to me there is a real opportunity for the actuarial profession to make the case to those who will be seeking long-term solutions to the credit crisis. Who knows, in the future we may be welcoming "credit actuaries" into our professional fold. ✦