Market Risk Masterclass Training

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INTERVIEW WITH TRAINING LEADER

Andre Horovitz

Andre Horovitz is the Founder of financial risk fitness. He has over 20 years experience in the Financial Services Industry. Mr. Horovitz started his banking career at Lehman Brothers as an Investment Banking Associate in 1988. He was responsible for... **Read more**

Why do regulators like VaR? Where does it fail?

Regulators like VaR as it is a measure capable to bring all classes of risk to a common denominator across all risk classes and risk factors: a loss based statistical measure. Succintlz, $1 million of 99% tail end VaR from Market Risk represents the same loss of value as one stemming from credit or operational risk. Of course, VaR is - as any other measure not infaillable: The fact that one is likely to lose tomorrow $1 million+ at a confidence level of 1% doesnt't mean that she cannot losethe same or more tomorrow and the day after tomorrow, thus depleting the firm's capital base. Also, the measure only tells us that the investor can lose no more than that amount within a given confidence level. The loss above that level can be $1.1 million or $100 million - there is no link to establish a relationship to that!

How can financial institutions incorporate and manage Non-Linear Risk?

Financial Institutions highly sensitive to non linear risk employ full revaluation techniques which value their portfolios for evey possible change in any probable combination of risk factors. Such systems are rather complex and expensive, but may help managers better limit and control market risks for complex, non-linear products.

What is the regulatory impact for risk management? What will Basel III bring?

Basel III better aligns "tangible" capital to financial risks while incorporating funding liquidity and financial leverage as key risk factors. Above and beyond, it adresses numerous shortcommings and loopholes present in the previous capital accord (Basel II) such as enhancing capital for counterparty default risks inherent in structured financing transactions and OTC contracts and/ or securitization transactions. Having said that, numerous critics argue that an "orthodox" implementation of Basel III at this point in the Economic cycle may take capital away from te real economy at a time when it needs it most for the post crisis recovery. Also debatable are the utilities of the various buffers especially those for the "global systemic important financial institutions"

Which are in your experience the biggest traps in Market Risk Management?

Interestingly, a lot of the academic literature along with many regulatory stimulations center around the proper and correct valuation of complex products under extreme scenarios. By no means, this is indeed an important issue and we´ve seen lately an industry drift away from the tenet of "same valuation formulae for P&L and Risk calculations". Indeed, an instrument might be valued with one formula under normal market conditions and with an augmented - sometimes entirely different formula under extreme market conditions, often coupled with heavy liquidity shortages and hedging inaccuracies.

But in my personal experience, there is a second "point of danger" relating to the practical imprecisions associated with "dimensionality reductions" of large portfolios omnipresent in most market and trading books these days. Indeed, by mapping positions to a limited (read: manageable) set of risk factors and reducing the dimensionality of the portfolios (various techniques ranging from eigenvector decomposition, Cholesky factorization, fast Fourier Series, etc. are practiced) the "new portfolio" often may lose significant components that could be material under some risk scenarios - a danger not to be taken lighly. The 2 day market risk seminar I run deals with practical means of checking such situations and acting upon their occurrences in a spirit of best capturing the risks inherent in the products while not reverting to impractical dimension explosions.

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INTERVIEW with Andre Horovitz

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