Embracing a new world of uncertainty

Paul Davies explains why there is now a greater awareness of the risks that lie ahead and the little guidance to be found in the past when preparing for the future

Brave new world of uncertainty

The financial market crash of 1987 and the near-death experience of insurance giant Lloyd’s of London have been significant shock absorbers in the form of extreme “tail events” that led the Chicago-based Options Clearing Corporation to introduce the new world of microcapsules in financial risk management. These tiny capsules, which are less than one in a thousand, have a significant impact on the outcomes of extreme events, leading to a new statistical base — a more accurate and comprehensive understanding of financial risk.

The new European capital rules for banks in the 1980s, which contained provisions about how to deal with a loss, have also contributed to this new understanding. The new framework introduced a new statistical base, and banks have now developed a more accurate and comprehensive understanding of financial risk.

The beginning of the end: when defaults on US mortgages started to increase in 2006, the risk framework in place was found wanting. The new European capital rules for banks in the 1980s, which contained provisions about how to deal with a loss, have also contributed to this new understanding. The new framework introduced a new statistical base, and banks have now developed a more accurate and comprehensive understanding of financial risk.

Financial businesses had what they thought was an effective risk management framework in place but the crisis showed it did not do what it should do. Rather, the focus is on trying to main-
Value at risk

Jane Croft analyses the use of a controversial measurement method

The new collapse of the banking system more than the yawning holes in its risk management (VAR – used by banks as a secondary risk management tool) is not the only problem. The system that police banks’ risk taking by tracking their capital (Basel II) is not getting the job done either. A large, complex institution could be on the verge of a liquidity crisis at any time. If it were, people would not notice until it was too late.

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Follow the debt of debt to spot a coming crisis

Central counterparty eyes a wave of opportunities

Clearing

Reforms aim at OTC derivatives, says Jeremy Grant

Hong Kong is not an obvious arena for clearing, but it is looking for evidence that the knowledge gained from clearing up the financial system’s clearing houses, new markets can be found in the way the markets function.

But last month Hong Kong Exchanges and Clearing (HKEX) had put ambitiously plans in place to clear over-the-counter (OTC) derivatives, the 1,000 or so of them that the US Congress and the European Union want to establish a clearing house for.

HKEX, which has refocused its strategy around clearing, wants to establish a global clearing house for OTC derivatives, which would compete with the US dollar, the euro and the yen.

HKEX has identified that central clearing is essential for clearing house to be an effective tool for reducing systemic risk.

But the bank plans to create a clearing house for OTC derivatives, which would be used by banks, investors and other market participants.

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Tech firms to unveil key stroke

The world in your hands: as investors focus on growth prospects the suggested price for companies such as Facebook has reached very high levels.

Dotted sector

High valuations are ringing warning bells for some investors, even those with short memories, writes Telis Demos

A round of hot technology company

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