ISMA

International Securities Market Association

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The risk revolution – are the capital markets ready?

(LONDON, UK) THE PROFITABILITY of investment banks and financial institutions over the coming decade will be influenced heavily by new attitudes towards risk management and risk allocation, according to an independent report published today by the International Securities Market Association (ISMA).

The Risk Revolution and its Impact on Securities Markets embraces the results of a major survey of ISMA member firms. The survey gauges a collective, global view of the challenges confronting participants in the international capital markets in the face of growing competition which, according to its findings, threatens to reduce margins by 50% or more in the next five to ten years.

In the report, author Andrew Freeman explores the business of risk, and explains how the conventional sense in which banks and financial institutions provide solutions for those seeking to manage, or assume, a given set of risks is undergoing fundamental change. Freeman believes that new financial engineering skills, coupled with irreversible inroads being made by insurers into the long-established territory of capital markets participants, have the potential to create a serious challenge to the traditional role of investment banks in the management and distribution of risk. His observations and conclusions are intended to stimulate new thinking by ISMA members, and other market participants, as to how to respond to the transformation.

Drivers for change – a better understanding of risk

For ISMA members, greater customer sophistication is one of the main factors likely to influence their business in the years ahead, possibly limiting their ability to act as intermediaries. However, they also believe that complex and tailored financial contracts will have the greatest influence on markets. In an environment where derivatives have rapidly come to occupy a central role in financial activity, Freeman identifies technology as the driving factor behind intermediaries' new-found ability to shape these new, bespoke instruments, which might embody any combination of risks for which a potential market exists.

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The report argues that an improving understanding of risk - not only by financial firms but also by corporations and conglomerates - is increasingly enabling the creation of, and demand for, securities - such as catastrophe bonds - which have specific characteristics and pay-offs and which allow corporations and individuals to alter their risk profiles: "The more a risk can be made specific, the more likely it is that it can be accurately priced and, consequently, the greater the chance that it will be acquired by an end-investor whose balance sheet is best equipped to absorb it. Financial engineering skills have allowed different tranches of risk to be calibrated with impressive precision," notes the author.

To exemplify how a security might be unbundled to reveal, and separate into components, a broad range of financial and business risks, the report suggests that the potential risks faced by an oil company could be divided across exploration risk, production risk, and short-term oil price risk. Instead of a single bundled equity, the firm might issue an array of different securities from which investors could select those most suited to their attitude to risk. As the increased use of securitisation has encouraged banks to accept the concept of packaging loans and removing them from the balance sheet, they have also learned that investors will only buy such securities if they are appropriately priced in relation to the risks embedded within them.

New territories

In Freeman's view, the trend towards risk allocation has suffered a troubled acceptance by banks, brokers and insurers, who have customarily performed long-established and pre-determined roles in the overall financial system. In recent years, however, the conventional barriers between different types of organisations have begun to collapse and, subject to regulatory limitations, give way to a greater overlap in their businesses: "Firms in one sector have become aware that their competitors are not just their obvious rivals, but include institutions from quite different sectors as well as new entrants," he says.

For Freeman, significant advances into financial intermediaries' established territory are being made by insurance firms. In a context where a corporation's chief financial officer increasingly sees financial risk management and insurance as intrinsically connected, the traditional gulf between the two disciplines has begun to create new opportunities for financial innovations. Freeman illustrates this point by reference to a policy underwritten for British Aerospace (BAe) in late 1998. BAe had been close to bankruptcy in the early 1990s when it had to write off USD 1.6 billion of losses associated with leasing activities outside its core business of manufacturing aircraft. Having studied capital markets solutions but finding this route too costly, BAe turned to a specialist financial modelling firm to piece together an insurance solution. The deal underwritten enabled BAe's stock to trade unhindered by exposure to a range of unattractive risks relating to its unsuccessful leasing business.

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Going forward

In the future, the report suggests that the level of sophistication that insurers are capable of achieving in structuring solutions to risk management requirements is likely to increase. The next phase of financial guarantees might, for example, see insurers guaranteeing the number of seats sold by an airline or the tons of steel sold by a manufacturer. From there, Freeman asserts, it is a short step towards guaranteeing earnings.

Despite these actual and potential developments, only a small proportion (11.4%) of ISMA members responding to the survey regard insurers as those best placed to benefit from changes in corporations' appetite for risk management. For Freeman, this view underestimates the power of the insurance industry in the evolution of securities markets and needs radical and urgent change: "Securities firms that successfully pursue the opportunities presented by current technologies will go about as far as is possible towards having a chance of existing by the end of the 21st Century. There is precious little room for complacency in today's financial industry," he warns.

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Notes for editors

1 ISMA

The International Securities Market Association (ISMA) is the self-regulatory organisation and trade association for the international securities market. For more than 650 member firms in fifty countries world wide, ISMA oversees the efficient functioning of the market through the implementation and enforcement of a self-regulatory code covering trading, settlement and good market practice. The Association also provides its member firms - and other users - with a range of services, products and support. ISMA owns and operates COREDEAL, the electronic exchange for international securities which, subject to regulatory approvals, goes live in April 2000.

2 The author

Andrew Freeman is European Business correspondent on *The Economist*. Until November 1999 he was Editor, Financial Services at the Economist Intelligence Unit and Editor of *Strategic Finance*. From 1994-97 he was American Finance Editor for *The Economist* in New York. Prior to joining *The Economist*, Mr. Freeman worked for the *Financial Times*, reporting on the Euromarkets from 1988-90 before writing on the Lex column. In 1992 he joined *The Economist* as the newspaper's London-based Banking correspondent.

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Mr. Freeman is the author of numerous articles and reviews for leading publications, speaks at conferences and has made regular radio and television appearances. In September 1994 his essay "The future of finance: capitalism without owners?" won a silver medal in the annual American Express Bank essay competition. He is also the co-author with Ron Dembo of *Seeing tomorrow: rewriting the rules of risk*, published in 1998 by John Wiley & Sons. He is currently writing a book on portfolio management.

3 To obtain copies

Copies of *The Risk Revolution and its Impact on Securities Markets* may be purchased at a cost of GBP 20.00 for UK customers (plus delivery charge). Further details are available from the Sales department at ISMA Limited, London on telephone (44-20) 7538 5656.

Review copies for media representatives are available free of charge. Please contact one of the individuals listed below.

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