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Gross versus Net Risk Management

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Day-to-day risk management practices should focus on outcomes that happen most of the time, avoiding the tails of distributions. Think of it as a regime switching environment, and the less volatile distribution works well for normal times. Net risk exposures, assuming that counterparties pay up, work well here. Nassim Taleb calls this Mediocristan. This could be referred to as a trader's environment.

Occasionally, events occur that are so infrequent that no one remembers the last time it happened (or it is completely new). This is the tail of the distribution, what Taleb refers to as Extremistan. For insurers this is the difference between required capital and reserves. Required assets are the assets that need to be held for a high level of comfort that they will be enough. Reserves are the amount needed for a lower level of comfort, and capital is the difference between the two. You can't calculate capital directly using this method. Under previous methodologies capital was driven by factors that were developed using more complex methods. Products are more complicated and designed by mathematicians who can avoid any rules based regime. Principles and accountability need to be used today. For external, regulatory purposes, using net risk is adequate.

But for internal purposes the risk team should go further, considering stress tests that assume some counterparties are not functioning or that the entire financial system locks up. This nearly happened in early 2009. In these scenarios it is appropriate to look at the risk before risk mitigation, the gross risk. Company management and the board can then decide whether these situations are acceptable under the company risk appetite. How resilient does a company expect to be? Some will choose to take the chance of a global meltdown, some will not. The choice should be transparent to other stakeholders, although it might need to be explained to them.

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