

# A Tale of a Two-Sided Coin

*One of the most important lessons to be drawn from the global financial crisis is that the market had mispriced the risk. A firm that cannot properly value its assets cannot effectively manage its risks. But valuation and risk management are really two sides of the same coin: both disciplines require similar skills and knowledge to be accurate and effective.*

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Looking back at the global financial crisis starting in 2007, many have observed that certain financial assets were overvalued because the market underpriced risk. The dislocation in global financial markets around that time served to highlight this to market participants. In hindsight, these observations may be clear. But, looking forward, what lessons can we draw from this experience?

One critical lesson is that risk management and valuation are interrelated, and that risk managers need to have a thorough understanding of the drivers of value in order to manage risk. Many firms, most notably hedge funds (especially the smaller ones), may not have had processes as thorough as some of their larger counterparties (e.g., bulge-bracket investment banks), and may have been more susceptible to valuation-related problems.

However, even some of the largest financial institutions are the subject of lawsuits accusing them of artificially inflating asset values on their books. If we have learned anything, it is that the valuation aspect of risk management should be addressed carefully.

Of course, even the best risk management practices may not have protected firms from the recent downturn: while a rising tide may lift all boats, a falling tide lowers them. However, a risk management program that effectively addressed valuation issues may have led to better outcomes financially, and also helped prevent some of the litigation and regulatory actions that have inevitably followed the enormous drop in global wealth.

Risk managers often have focused on issues such as financial diversification, security of information technology and other safeguards; all are important issues. But the exotic financial instruments that were at the center of the crisis, including derivatives and structured products, are the financial instruments that were hardest to value. As more complex financial products were deployed, the risk of inaccurate or flawed valuations grew. Continuing uncertainty and illiquidity in the markets have compounded this risk.

Unfortunately, in many cases, risk management is seen as separate from the valuation function, resulting in an apparent disconnect between the two. Risk managers must be cognizant of the important role that valuation plays in risk management, have a strong grasp of how assets and liabilities are being valued, and fully understand the linkage between the key valuation drivers and the major risk factors.

One long-term positive implication of the recent financial crisis may be the exposure of deficiencies in valuation prac-





