



# Risk management in volatile markets

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# Regulatory context

“A firm must have robust governance arrangements, which include..... effective processes to identify, manage, monitor and report the risks it is or might be exposed to.....”

SYSC 4.1.1



# Characteristics of external volatility

- Heightened risks for FX brokers and for their clients;
- Sentiment-driven swings in rates;
- Absence of rational behaviour;
- Loss of confidence and lack of certainty drive lower trading volumes;
- Potential for credit or m-t-m losses arising from business failures;

But...

- Opportunities as well as threats.

# Risk Management Framework

- What are the risks to our business posed by
  - normal business operations;
  - external stresses which we can't control?
- What can we do to we control or mitigate these risks?
- What is the financial impact if these risks materialise?
- Is there an appropriate process we can implement to manage them effectively?

## Suggest ICAAP framework

- Compulsory for investment firms;
- Recommended for all other firms.

# ICAAP (Internal Capital Adequacy Assessment process?)

- Capital Requirements Directive (CRD IV) – Pillar 1 and Pillar 2 assessments;
- Pillar 1 - assessed on balance sheet and m-t-m positions.
  - credit risk;
  - market risk;
- Pillar 2 (ICAAP) – assessed on latent risks within
  - business strategy;
  - operations and processes;
  - systems.

Consider different scenarios - normal course of business, stressed, orderly wind-down.



# Risk Framework - How

- Develop / review your risk register
  - identify risks carried in the normal course of business;
  - consider probability and impact of each risk occurring;
  - identify control measures and assess the extent to which they mitigate the risk.
- Understand the risks carried
  - are you comfortable with the level of risk carried?
  - is it possible/feasible to mitigate it further.

# Risk Framework – here's one we made earlier

BUSINESS RISKS			Probability 1 - 5	Impact 1 - 5	Gross Risk (P * I)	Nature of Mitigation	Probability 1 - 5	Effectiveness 1 - 5	Risk Mitigation (P * I)	Net Risk (col G - col L)	Sensitive to External events	Insured Risk	Estimated Loss
Risk Groups	Risk Nr	Nature of Risk											
IT	1	The risk of failure of power, IT & Communication			0				0	0	No	No	0
	2	Data security breach			0				0	0	No	Yes	0
	3	Software upgrade failures (insufficient testing)			0				0	0	No	No	15,000
Operational	4	Sued by employees			0				0	0	No	Yes	0
	5	Loss of key staff			0				0	0	No	No	5% of income
	6	External/internal fraud			0				0	0	No	No	60,000

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# Stress Testing

- Specify characteristics of stress test scenarios (FCA suggest for significant IFPRU firms)
  - circumstances and events occur over a protracted period of time (eg global economic recession/depression);
  - sudden and severe events eg market shocks;
  - some combination of both.
- Quantify impact on your P&L;
  - loss of income eg severe decline in volumes traded;
  - increased, unbudgeted costs eg redundancy payments for staff laid off);
  - uninsured litigation fees; or
  - credit and/or m-t-m losses.

NB identify losses incremental to normal-course-of-business losses.



# Orderly wind-down

Consider potential costs incurred in an orderly wind-down of your business:

- over what period?
- at what rate would your income decline?
- are there costs incurred in breaking existing client/supplier/employee contracts?
- how long will it take to realise your assets and will they have to be sold at a discount to book value?
- what level of professional fees are required?
- what is the risk of client/supplier default?

# Quantify your risks

Cost of risk  
carried in  
your business

=

The higher of  
(normal-  
course-of-  
business risk  
+ stress  
losses)

or

(costs of  
orderly wind-  
down of your  
business)

# Recommendations

Check your own risk assessment framework to ensure that:

- you document risks for each function in your business and you formally review them on a quarterly basis;
- you understand the risks you run in your business;
- the mitigating measures on which you depend are being properly applied;
- you can sustain the level of estimated losses, both in terms of net income and cashflow;
- there is regular board and senior management oversight and agreement of your risk management framework.



**For more information, please do not hesitate to contact us:**

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