

Risk Management in a Stock Brokerage

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The goal of a risk management system is to measure and manage a firm's exposure to various risks identified as central to its franchise. For each risk category, the firm employs a four-step procedure to measure and manage firm-level exposure. These are: 1) Establish Standards and Reports; 2) Impose Position Limits and Rules; 3) Set Investment Guidelines and Strategies; and 4) Align Incentive Contracts and Compensation.

Step 1. Establish Standards and Reports. A standard is a point against which a client is measured. In general and not only among brokers, certain standards must be met before rating a company or a client. A report given to management may follow a standardized format that requires presentation of information in a structured way for ease of use or understanding. Standardized financial reporting is essential for investors to gauge asset quality and firm-level risk. The need goes beyond public reports and audited statements to cover management information on asset quality and risk posture. Internal reports need similar standardization and greater frequency. Managers need to be sensitive to changes in macro and micro environmental situations, and to enhance stakeholder certainty through effective communication of accurate information.

Step 2. Impose Position Limits and Rules. A key element of financial risk management is deciding which risks to bear and to what degree. A firm needs to impose limits to cover exposures to counter-parties, credit, and overall position concentrations relative to systematic risks. In general, everyone who can commit capital -- traders, lenders, and portfolio managers -- should have a well-defined limit. An example is the check signing authority and the amounts for each level of authority. Summary reports to management can periodically show counter-party, credit, and capital exposure by business unit. In large organizations with daily transactions and thousands of positions maintained, accurate and timely reporting is difficult but essential. Principles of accountability, transparency, and improved financial performance are being translated into demands to quantify and measure as much operational activity as possible and correlate that activity to the business plan.

Step 3. Set Investment Guidelines and Strategies. A firm should outline investment guidelines and strategies for risk taking in the immediate future in terms of commitments to a particular market area, extent of asset-liability mismatching, or the need to hedge against systematic risk at a particular time. Risk management involves determining what risks a firm's financial activities generate and avoiding unprofitable risk positions. The board's role is usually described as setting the risk appetite of the organization; however this is not possible if risks are understated or ill defined. Guidelines can advise on the appropriate level of active management, given the state of the market and senior management's willingness to absorb the risks implied by the aggregate portfolio.

Step 4. Align Incentive Contracts and Compensation. The need for elaborate controls lessens when management can enter into incentive-compatible contracts with line managers and relate compensation to the risks they bear. For example, management can offer a salary level without commission. Commissions encourage salesmen/traders put in more transactions because of the commissions. Most foreign houses have salaried personnel and do not have agents.

In most journal articles risk management focuses on banking institutions. However, there is far less discussion of risk management of securities firms. Stock brokerages face operational, market, credit and regulatory risks. Securities firms engage in various financial activities, particularly serving as brokers between two parties in transfers of financial securities, and as dealers and underwriters of these securities.

Operational risk is the risk of monetary loss resulting from inadequate or failed internal processes, people and systems or external events. For the stock broker, operations risk is essentially counter-party risks such as non-payment, non-delivery of scrip, denial of matched order by client/s, trading errors, and sudden closure of banks where funds are deposited

The main risk arising from securities activities is the market risk associated with proprietary holdings and collateral obtained or provided for specific transactions. Market risk refers to the possibility of incurring large losses from adverse changes in financial asset prices such as stock prices or interest rates. This risk entails the erosion of value of marketable securities and assets, due to factors beyond an enterprise's control. Market risk is usually affected by economic developments, political destabilization, rising fiscal gap, and national debt, terrorism, energy price shocks, increase in interest rates, all resulting in a drop in equity prices.

Regulatory risk occurs when the rules governing the securities industry are changed, giving rise to potential loss. For example, a customer first policy makes it difficult to trade house accounts and therefore a brokerage may not be able to liquidate a position immediately, leading to potential or actual loss. A new rule that requires brokerages to maintain a higher net capital may be hard to meet.

Another example of regulatory risk was created when the Supreme Court ordered Meralco to refund its customers and excluded a particular tax from Meralco's cost or computation of return on rate base (RORB).

The stock brokerage firm faces regulatory risks if it fails to meet net capital requirements, commits violations in the hiring of market professionals and other personnel, and fails to comply with anti-money laundering requirements.

An improving Gross National Product and foreign exchange rate are considered good news for investors. This encourages them to invest -- currently, in Manila Water's and SM Investment Development Corporation's

initial public offerings. The Phisix continues to rise above the 2000 points level, led by telecommunications companies Philippine Long Distance and Telephone Company, and Globe. There is also renewed interest in mining issues, after the Supreme Court ruled early this year that foreign investors can invest in the mining companies.

A stock brokerage firm must identify factors that can trigger operational, market, credit and regulatory risks. It needs to establish procedures so that risk management begins at the point nearest to the assumption of risks. This means adapting trade-entry procedures, customer documentation, client engagement methods, trading limits, and other normal activities to maintain management control, generate consistent data, and eliminate needless exposure to risk.

The Philippine Stock Exchange has required stock brokerages to have compliance officers to ensure trading integrity. The stock brokerages are also moving toward risk based capital adequacy and may eventually abandon net capital. Perhaps they can look at the Sarbanes-Oxley Act, which includes guidelines for proper behaviour and a mandate to institutionalise documented controls, lines of communications and preventive measures to discourage offenses, as well as detect and correct gaps.

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