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VaR and its Role in the Credit Crisis

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by Mark Kirkland, VP Treasury, Bombardier Transportation

The causes of the credit crisis of 2009 will be discussed by many for numerous years to come, although probably for fewer years than we now think. People have a unique ability to forget, perhaps black out, the worst episodes. I have sat down on a number of occasions and tried to think, what were the possible causes of the crisis? An inherent weakness in accounting of results, large numbers of over the counter derivatives with large fair values, weak governance by regulatory bodies or even that bankers were paid too much? In the end, I believe that none of the above was a key contributor to the crisis. In my mind there are two unrelated causes.

The first is the mode of compensation in the financial industry. Not the amounts. Most bankers receive a kind of option pay out. If the firm makes a large profit (based on the mark to market of future uncertain cash flows), the employees receive large cash bonuses. If the firm makes a loss, in the worst

case, staff may receive no bonus. Clearly, for a betting man, this gives carte blanche to load up the company with significant risk. Since most bonuses are not discussed with the owners of the company (the shareholders) but set by a compensation committee, often chaired by senior employees, there is a tendency to overpay since this justifies the compensation of the very people making the decisions. I will not dwell on this cause much longer – except to stress that the whole model encourages large risk taking.

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The second is the point of this article. Risk was and still is, very badly understood, managed and reported. It is now clear that very few shareholders of banks understood the risks that some banks were in fact taking. In part, this is because disclosure of risk is unclear. A more fundamental issue, however, is that it appears that some of the banks did not fully comprehend the risk and actually outsourced much of their risk assessment to the rating agencies and then used flawed measures such as Value at Risk (VaR) not only to manage risk but also to report to management and shareholders alike.