The risk landscape in the asset management industry has changed in recent years and new stresses and challenges continue to emerge. In this Q&A, William D. Mennonna, managing director and chief risk officer of PNC Capital Advisors, discusses some of the key risks faced by investment firms in today’s environment and the tools that may be used to counter them.

**How has risk management changed since the 2008 financial crisis?**

Even before the crisis, many asset management firms were moving toward a centralized risk management model. However post the 2008 crisis, firms like PNC Capital Advisors recognized the need to refocus the risk management discipline to be more holistic, encompassing not only operational risk but also investment and counterparty risk. Although asset management firms have been managing risks for many years, some risk management functions had been siloed into different areas. For example, the management of investment risk was embedded within the portfolio management teams or as part of the quantitative analysis function. Since the 2008 crisis many firms now have centralized risk management oversight functions, which include operational, counterparty, and investment risks – otherwise known as the three pillars of risk management. Having over 14 years of asset management experience I’ve been following this trend closely, but more importantly I’ve been benchmarking against some of my risk management peers in the industry.

**What types of stresses are you seeing today?**

We are seeing several stresses in today’s markets. For example, deflationary issues in Europe and now China, and more recently concerns surrounding the potential default of Greece and...
Puerto Rico. As far as the U.S. is concerned, highly accommodative monetary policies by the Federal Reserve (Fed) since 2009 have kept things quiet. However, we’re seeing signs of potential illiquidity in the bond market. In general, broker-dealers now have less capacity for holding bonds in their inventory than they may have had in the past or even during the 2008 crisis. This is particularly true for the bank-owned broker-dealers where regulatory constraints have impacted their capital at risk.

This has been caused in part by regulations that have impacted banks, such as the Dodd-Frank financial law, which affected the broker-dealers that are owned by some of the larger banks. Specifically, enhanced capitalization requirements have caused banks to shift capital away from their broker-dealer subsidiaries and back to the bank’s balance sheet. And subsequently some of the bank-owned broker-dealers (who act as market makers in the fixed-income market) now have less capacity to hold bonds in their inventory than they used to, which could potentially cause illiquidity problems. We don’t know what’s down the road, but what’s concerning is the lift-off from the Fed on an interest rate increase and whether that will precipitate a sell-off in the bond market, causing everyone to run for the door at the same time. The big question that remains is will this create a liquidity crisis? In some respects, the market is already seeing some early warning signs in the repurchase market, with less availability in the triparty repo market.

**What steps can asset management firms take to minimize their risk of illiquidity?**

Well, first having a well-diversified portfolio in several asset classes and sectors, and higher quality bonds can help to minimize this risk. But more importantly, continually monitoring the underlying holdings and assessing the ability to either purchase or sell without impacting the overall price in the market. For portfolio managers today, much of that monitoring is an art versus a science. But there are tools that are becoming available to gauge the market impact and trading volumes in order to help assess liquidity risk. For example, we currently use Bloomberg’s multi-factor risk model to analyze the risks for our fixed income and equity portfolios. In addition, Bloomberg will soon be releasing a fixed income liquidity monitoring tool, which will help us monitor that type of risk. Other ways to minimize the risk of illiquidity is to set up redemption lines of credit for certain portfolios. These lines can be accessed in times of stress and act as short-term shock absorbers should a particular fund experience higher volumes of redemptions.

**Banks continue to show up in the headlines and have faced an increasing amount of scrutiny along with a host of new regulations like Dodd-Frank, Volker, and Basel III. Are there any benefits to being an asset manager within a bank?**

As an asset manager owned by a large bank there are definitely some benefits, such as leveraging the strong risk governance structure and the bank’s technology infrastructure, specifically the cybersecurity oversight. In discussions with many of my peers who work for standalone asset managers, this is an area they feel needs more attention. Many asset managers are now attempting to revamp or enhance their cybersecurity defense postures to meet the increased level of threats. As you may have seen in the press, cybersecurity is something that the SEC is focused on and they have started a number of focus exams of asset managers in this area. I believe that PNC is well ahead of the curve in the cybersecurity area, deploying a significant level of resources and following leading practices to mitigate a number of threats and vulnerabilities.
Another distinguishing characteristic at PNC is the strong emphasis on risk management and the tone at the top, from PNC CEO William Demchak on down. Not only that, a lot of asset management firms are trying to revise or develop their risk appetite statements, which PNC has already done.

There’s also our dedication to risk management and to holding every employee accountable to those standards, a distinguishing factor from some of our peers in the asset management space. It makes a risk manager’s job a lot easier when you don’t have to try persuading other managers to think in terms of managing risk. These are all areas that PNC Capital Advisors has been able to leverage, particularly as it relates to due diligence reviews from our clients or prospective clients. Risk governance, post the 2008 financial crisis, is also an area that external parties are focused on when they are evaluating firms.

**As the chief risk officer of a $40 billion¹ asset manager, what keeps you up at night? What concerns are the most pressing in the world of risk management today?**

Here are a few that keep us up at night: cybersecurity, liquidity concerns, and disruptions in the market such as a flash crash. As previously mentioned, I’m not so concerned with cybersecurity within PNC, I’m more concerned with third-party providers or with market exchange providers such as the Nasdaq or NYSE, where there have been disruptions and cyber attacks. I worry about their security posture or inability to detect an attack on a timely basis. There has definitely been a spike in the number of Wall Street firms that have been attacked. From a stock exchange standpoint, there have been a few incidents in the past few years and then you have the whole cyber terrorism issue with North Korea, China, and Russia. One concern from a state-sponsored cyber terrorism threat is an attack designed to disrupt or knockout stock exchanges, brokerages, and major Wall Street firms.

Regarding the flash crash, this is something that is still a concern particularly in light of a recent revelation that the 2010 flash crash was caused by one individual trading e-mini futures. According to recent articles, this individual deployed a tactic known as spoofing, entering a large market order and then subsequently cancelling that order. Combining the flash-crash issue with cybersecurity threats, has exposed some vulnerabilities in the exchanges.

**Looking in the rear view mirror, some say we could have averted the financial crisis in 2008 by paying attention to the stresses in the system. Do you think we are facing any stresses in the system today?**

From a risk management practitioner standpoint, we learned a lot from the 2008 crisis about how to defend against the next 100-year flood. It caused us to be more vigilant regarding some of the telltale signs in the market today, such as the liquidity concerns. With the 2008 crisis, one of the things we learned was that credit default swap yields are an important metric to gauge the financial health of firms or counterparties. As credit default swap yields widen, it provides a forward-looking metric of market risk and potential stresses and provides a measure of which firms could be going bankrupt or defaulting.

Within PNC Capital Advisors, the risk management team routinely keeps a close eye on our top portfolio holdings. We’re monitoring those exposures on a regular basis – things like their credit default swap spreads, their stock price changes, important news events, and their credit ratings. That’s in conjunction with the portfolio managers who also closely monitor those exposures.

More importantly, since the crisis there has been a proliferation of risk management tools that have come on the market that were designed specifically for risk managers. It’s something the market has risen up to address. The same goes for managing operational risk and investment risk – the field has expanded with several leading providers offering risk-management tools for those types of risks as well.
A New Era In Risk Management

**Flash crashes and the impact of dark pools dominated the headlines for a long time, but it seems as though the fear of those type of market events has diminished. Any thoughts?**

As mentioned previously, what’s concerning about the 2010 flash crash is that five years afterward, they’re just discovering the possibility of a smoking gun. The individual allegedly behind the crash is now awaiting trial in the U.K. If the allegations are true, can one individual really cause such damage to the financial markets? But as I mentioned before with the increases in the number of cybersecurity threats that there have been, exchanges like the NYSE and the Nasdaq are attempting to increase their resources toward cybersecurity. And that might also create a speed bump to slow down high-frequency trading by requiring the exchanges to do some validations of those trades.

I’m not that concerned about dark pools. If used as intended, I think they actually do serve a purpose in the market in terms of providing anonymity on the some of the larger trades where you don’t want to tip your hand.

**What about operational risk? What are the chief concerns and how do you address them at PNC Capital Advisors?**

Asset managers have been spending a lot of time on operational risk and it’s no different at PNC Capital Advisors – it’s been a focus at the firm for many years, even before the financial crisis. The goal is to identify, measure, and quantify operational risks that impact our day-to-day core business, such as trading in the equity and fixed-income markets. As part of that risk assessment, we want to make sure the proper controls are in place to mitigate any unforeseen issues. We keep an inventory of those risks and periodically assess how effective the controls are and whether there’s any substantial change to the risk profile. As an extension of our operational risk inventory, we also keep an active list of emerging or top risks impacting the firm.

PNC Capital Advisors views risk management as an integral and continual process that offers benefits and insights for our firm and our clients. We believe that a disciplined risk management process combined with close monitoring and the effective use of available tools can counter and protect against risks and stresses that may arise in the ever-changing investment environment.

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1 AUM $39.8 billion as of June 30, 2015.