Libor
the risk lesson

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The July / August 2012 edition of the Global Risk Update is being published at a time when both banking and the global economy are coming under intense scrutiny. The succession of operational and economic crises that seem to be impacting our industry continue at a steadily increasing pace. In this issue we focus on some of the key factors that are involved and our take as to improve general risk management in the industry. In our lead article Mary Phibbs, an experienced international banker, chartered accountant and risk professional, discusses the Libor fixing issue. Her insights take the discussions right back to square one – who’s in charge? This is an area where we believe the story has not as yet been fully explored and I am sure you will find most interesting.

In the following two articles we explore the role of the chief Risk Officer and any barriers that exist implementing an effective enterprise risk management framework. In practice firms are finding it hard to successfully implement risk management. Taken together these two articles provide advice and guidance leading to successful implementations.

The 4th article looks at the debt crisis in Europe from the perspective of Spain. Interestingly it concludes that some of the obvious options were not actually used. Our view is that they would have been effective options to consider.

Islamic finance is on the move as traditional finance continues to suffer. In this article, Mark Andrews, Risk Reward’s lead in Islamic Finance provides an introduction to what is an increasingly important subject. Finally we provide an analysis of the recent BCBS paper on the role of internal audit in banking Clearly with so many problems being encountered the risk of internal audit needs to be enhanced. This paper provides a number of interesting challenges to be addressed.

We hope you enjoy this edition and look forward to your feedback either here or on our LinkedIn group. The Risk Reward Global Risk Forum

With best wishes

Dennis Cox BSc, CFSI, FCA
Chief Executive Officer
The banking world has been rocked again – this time by what may prove to be the fraudulent quotation of the London Interbank Offered Rate (Libor).

Libor has been used as a funding benchmark since it was used for pricing floating rate loan and bond products in 1970, and has become the principle rate used for many products in London and elsewhere, in many currencies and for many maturities. The British Banking Association (BBA) have owned and been responsible for Libor since 1986 and regard the misuse of Libor very seriously.

As press and media attention is being given to the Libor ‘scandal’ and Parliamentary sponsored enquiries and the Serious Fraud Office investigation gird themselves to identify wrongdoing and search for those responsible, work is in progress to rehabilitate Libor and make it fit for purpose for modern markets. These initiatives are crucial for industry and political reasons and will no doubt take quite a while to come to full fruition. But behind the scenes the much less exciting or newsworthy task of examining what lessons there are for risk managers has been well underway. The success of any changes that will be made will be the key factor in determining how banks can avoid the massive damage to their reputations such episodes can bring.

Much will be learned in the upcoming investigations about the mistakes made and how internal processes and controls failed to identify such a serious problem. Risk managers don’t need to wait before reviewing their own internal procedures and simulate how to react to the overt or accidental misquoting of rates.

Before a judgement can be made on whether or not fraud took place (in any of the banks involved) it is necessary to pull together the mechanism of how Libor was agreed internally, who had the obligation of sign off, which internal departments were involved or informed, and how far up the management tree any ‘outlier’ rates were reported. Board level oversight of Libor will not escape scrutiny.

Libor quotations can only originate from the trading desks or wherever treasury and rates businesses are located. What matters is the verification of the quoted rates by a function independent of any P/L responsibilities for trading operations. For decades dealing rooms and eventually the BBA would contact each other to agree rates for multiple maturities and currencies. This worked smoothly, with some disruption during times of significant market stress, and no sense of collusion or internal abuse dented the confidence in Libor. Its success led to Libor being used as a benchmark for many products, some of which it was not suited for – such as US sub-prime and some liability products. Whilst it is not the most pressing concern at the moment the risk of using the wrong benchmark is one that will have to be managed properly in future and is bound to have an effect of interest rate pricing policy. This is another example of how far the suitability test needs to permeate RM.

Irrespective of whatever misdeeds occurred there has been plenty of room for mistakes to have been made in quoting Libor as pure rates.

Mary Phibbs FCA, a Chartered Accountant has held Chief Risk Officer and other senior credit, risk management and audit positions at ANZ, Standard Chartered Bank, National Australia Bank, Commonwealth Bank of Australia, PWC, KPMG and Deloitte. She is now Trustee and Director at Charity Bank, Independent Director at Friends Life Group and was until recently a Non Executive Director at Northern Rock. In this article she reaffirms how risk management is ultimately directed from the top down while risk managers need to prevent or discover misquotations whether caused by mistakes or mischief.
Libor – the Risk Lesson

Markets evolved and became cross fertilised with derivative and collateralised products. Libor began as a funding rate in the London market for Sterling and Euro products alike and became the central rate for pricing IRS among other products. Rates desks became split between trading in repos, IRS, FRAs, futures, treasuries and other products, and the traditional treasury function became subsumed obscuring the rates that applied to pure funding. For a long while the various interest rate curves associated with these products were not far apart and they tended to move in tandem. It was only when the dislocation of unsecured interbank wholesale markets became obvious (in H2 2007, and especially 2008) that the cost of funds moved significantly higher than derivative and collateralised curves.

With the benefit of hindsight the risks of mis-quoting crept up on banks without risk managers being aware of them or realising the damage that might be caused by a curve being fixed some way away from the true cost of funds. We now know that traders quoting Libor were gaming internal P/L revaluations, but it is highly likely that Libor quotes were simply based on the wrong curve as well. The RM task is to prevent or discover misquotation whether caused by mistake or mischief. Many of the lessons learned in early 2000s from the Allfirst, (a North American Bank) and National Australia Bank cases of FX rate manipulation are transferable to how to address the risk mitigation applicable to quoting Libor rates. In both of these cases, FX losses were hidden by false revaluations which were not picked by any function outside the dealing room.

The RM lessons to be learned from this crisis can probably be divided into five categories:

- The Middle Office should ensure the alignment of the right rates for different interest rate products and act fully independently of the front office. The MO should do so for control and reporting purposes and have oversight of how those rates are used in lending or other, fixed income, or other product pricing divisions.
- Audit, finance compliance and risk departments must be adequately resourced with staff that understand interest rate structures, or be able to source independent skills internally or externally to interrogate benchmark rate fixings. They must also be adequately empowered to provide independent oversight and escalation.
- The reporting of Libor and other rate fixing through the RM division up to board level. There are at least three key risks to be monitored: the reputation risk to the bank; the legal risk of exposure to fraud; and the misuse of rates for product pricing purposes.
- The board and senior management in turn are responsible for establishing the right risk culture “From the top”. This is where there is a shared understanding of what is acceptable (and tangible consequence when behaviour deviates from this), they lead by example, there is clarity of accountability, transparency in decision making, remuneration and reward structures that drive the right behaviours and balanced outcomes and where there is respect for others particularly those in control functions such as Risk Management.

Waiting for the outcome of current investigations is not an option for the RM response to this latest crisis. It is not necessary to know the motives of those responsible to be able to upgrade RM and the whole risk culture of the organisation to give assurance that the legal, reputational and financial welfare of the bank is prioritised. If that work is not already underway, it should start immediately “From the top”.

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B
anking industry has been implementing risk based rules for many years yet we still seem to get banks having difficulties. Why then is this the case? Are Chief Risk Officers (CRO) at fault and how should you find the right CRO for your firm? In this article we will explore the role of the CRO and the barriers faced in practice, suggesting appropriate approaches and solutions.

The Role of the CRO
The Risk Department within a bank is the unit that facilitates the bank taking risk. It does not take risks itself nor is it responsible for risk being incurred. This is the responsibility of the Board of Directors as delegated to its business units. The Risk Department under the management of the CRO is entrusted with developing an environment consistent with prudent risk taking. They create the structure whereby the systems of procedures and controls implemented at business unit level ensure the necessary level of control is maintained.

To achieve this, the Risk Department needs to have a detailed understanding of the nature of the activities of the firm and have approved the necessary policies and procedures needed to ensure that this is achieved. Of course policies and procedures alone are not sufficient. They need to be combined with robust monitoring and reporting. All of this is well understood – yet continued problems do appear to occur. Is it the failure of the CRO, the Board or the Risk Management concepts themselves?

The CRO is the person who should provide the ultimate risk vision. They should ensure that the management have the necessary tools available to them consistent with prudent risk taking. In the current regulatory environment the market’s expectations are such that the level of direct involvement of risk within the business will be sure to have increased. Accordingly a more active involvement of the Risk Department and the CRO is required. But a CRO is only human and cannot be everywhere.

The CRO is reliant on the business implementing the systems and controls that are required and being honest in their reporting to the Risk Department, ensuring that adequate support is provided. If that information is incomplete or information is deliberately withheld then the CRO will not be in a position to provide their senior management with the information or direction that they require. Few CROs have been trained in all areas of risk management. In the case of commercial banks the majority of CROs have corporate credit risk as their key skill. In investment banks the route to the CRO is often through the market risk route. This can lead to a CRO having what might be best considered as being “hidden shallows” – that is that they have detailed experience of one area of risk management but are weak in another area.

This causes an obvious dilemma. Human nature means that the CRO will tend to focus their activity on the area of the business where their personal key skills are of greatest importance. They will essentially delegate their responsibilities in other areas to those who are experts in those fields – relying on their expertise. However, this leads to an obvious problem. In failing to have the ability to truly understand the additional risks that face the business the CRO is unable to appreciate the impact of one risk on another. Risk mitigation approaches that are effective in one area may have the unfortunate impact of actually increasing risk in another area. Further reverse or wrong way risk may not be fully appreciated.

Another problem is that the CRO is then rarely in a position to effectively implement consistent enterprise risk management (ERM). Fully fledged ERM is a clear requirement arising from recent Basel announcements, but should have been required regardless of any such pronouncements. The need to measure all risk on a complete and consistent basis has always been there. The problem is that with the CRO perhaps not being comfortable in all areas of risk there can be a

What Makes a Chief Risk Officer Great?

The financial press reports the names and career status of Chief Risk Officers on a regular basis these days as claims of scandal, insider trading, mis-selling and rate fixing abound. Global Risk Update Editor in-Chief Dennis Cox opts to offer a normative view of the role of the Chief Risk Officer and considers the pitfalls, limitations and what it really takes to make a great CRO.
The Risk Department under the management of the CRO is entrusted with developing an environment consistent with prudent risk taking.

developing silo culture. This was exacerbated by the BIS rules requiring capital calculation based separately on credit, market and operational risk – with liquidity, strategic and reputational risk delegated to Pillar 2. This resulted in an undue focus on a sub set of the risk universe with, as we have seen, and previously predicted, disastrous consequences.

The Role of the Board
Risk management is the responsibility of the Board. Again this has appeared explicitly within Basel III, for example, but was always the case. It is the Governing Body that takes responsibility for the activities of the business, delegating but not abrogating as necessary.

Too many Boards have not actually understood what this really means. They too have limited understanding of what Risk Management really is and what it should do. If you are within a single institution you know how things are done where you are. You know how you do things – but do you know how you should do things? How would you know that what you are looking at is sub-optimal? Of course they will ask the CRO, but as we have seen they may have hidden shallows and consequently not have the ability to provide answers to all of the questions that could be asked.

Increasingly it is important for Board’s to possess non-executive directors with appropriate risk skills to enable detailed and significant questioning of the CRO and business management to take place. From our experience few firms have grasped this obvious structural improvement and we have to date placed few risk non-executives within banks. The addition of a non-executive director with risk experience from other institutions would add significantly to the quality of debate on many boards.

The next problem for the Board is the problem if dealing with the future when the present is so complex. Shareholders and markets are clearly focussed on short term expectations which are impacted by the occurrence of what might be called non-goal correlated events. These events cause a divergence from anticipated results that may impact the career prospects of the Board themselves – but such events have occurred. The role of Risk Management is to develop a structure of systems and controls such that the likelihood of such events is reduced and their impacts mitigated where possible. This means that Risk Management and the CRO are often talking about things that might happen at some stage in the future (for example, the collapse of the Euro) when there are a series of risks which are much more likely that are poorly managed.

To make matters worse the CRO cloaks himself in what a cloak of false confidence believing in the sanctity of risk models and providing their output to the Board as if it is a mantra that must be understood. Combining the indigestible with the incomprehensible ensures that the appropriate level of discussion does not occur. The Board focussing on the here and now will delay their consideration of the Risk Management information and consequently fail to provide the necessary level of oversight that is both required and envisaged.

The Problem of Risk Management Itself
Is risk management itself the problem? Some consider that an industry has been developed that has no clothes. It is found wanting whenever there is a problem. Of course the CRO will say that it is not the concept that is at fault but the way that it has been implemented. But there are problems with risk management and these do need to be recognised.

The first issue relates to the need for consistent ERM as referred to previously. This needs a risk vision which will then be implemented throughout the business using policies such as risk appetite, risk reporting and risk acceptance. Yes there will be significant modelling but the concepts themselves need to be simple and easy to implement. Such modelling needs to be consistent with the risk vision such that the impact of events can be properly appreciated. CROs do themselves little service by stating the impact of such and such an event on credit risk is £x without being able to evaluate the total potential loss on the business.

Another issue relates to modelling. In the last 10 years or so modelling has been a major driver within risk management. It is prevalent in both credit and market risk and increasingly seen in counterparty credit risk, operational risk and liquidity risk. Strategic risk and reputational risk are still rarely modelled or measured even though appropriate techniques do exist to do so. To make matters worse much of the modelling that is conducted is at best unhelpful. We shall consider this further in the next section.

A final issue relates to what the Risk Department is actually trying to do. Most risk functions focus on two things – events that have occurred and unlikely but plausible events. This is like thinking that all that could happen to your car is a minor scratch or its complete destruction. Any number of events could occur and each requires different mitigating action. By focussing on events that have occurred the CRO is dragged into the day-to-day and its impact on budgeting and pricing. By then looking at the plausible but unlikely they are providing the Board with information that relates to an event that the Board do not think will occur. Of course the unlikely event that will occur is unlikely to be the one that has been looked at.

Risk Management is about looking at the distribution of risk from an area from expected to unexpected and everything in-between. It is as important to not over action a minor issue as to under action a major issue. Too many firms in my opinion
completely miss the point of stress testing and such problems also exist with certain of the so-called risk advisory firms.

The Problem with Models
Any model that is being used within a bank needs to have good predictive ability. It needs to inform management about the nature of some form of risk and lead to some form of action plan. Different problems exist with different risk types and even some of the market standard modelling approaches are currently ineffective. To make matters worse the CRO often provides data to the Board to a level of accuracy that the modelling does not deserve. Showing decimal places when the data could be 20% wrong in either direction makes no sense at all. Just because you have a calculation to four decimal places does not mean that this makes any sense at all.

In credit risk we are living in volatile times, which I am sure everyone recognises. This has the consequential impact that next year’s credit losses are unlikely to be based upon those incurred last year or in any prior year. This means any credit modelling system based on the use of historic data is unlikely to have good predictive ability and is likely to fail the required model validation test. Further we have even seen firms using corporate credit modelling systems that are based upon historic data for a different market, for example the USA. The rules and clear and it is actually also common sense. The model needs to be based on information relevant to that on which it is to be used. Such external models are of course of interest, but their ultimate value is limited.

If you are using a credit scoring system then the changing credit environment means that the model needs to be recalibrated and revalidated to ensure that it does indeed have a complete set of attributes. The validation needs to be conducted by ensuring that the model actually calculates correctly – it is clearly inappropriate to try to test one bad model by using another bad model. Again we are seeing both banks and their so-called advisors make such elementary errors.

In market risk the changed market conditions invalidate much of the modelling that has been conducted. We are now in an interest rate environment where the expectation is that the year-on-year interest rate movements will be upwards. The problem for the market risk modellers is that all of their quality relates to market where the year-on-year interest rate expectations were for rate reductions. In the absence of quality data the creation of synthetic data creates a level of uncertainty which is poorly understood. Basically many of the market risk modellers currently in regular usage would again fail an appropriate model validation approach. We have seen, for example, firms taking options pricing from 12 systems, ignoring the top and bottom 4 and then averaging the remaining approaches. There is a technical answer to this rubbish!

The weakness continues in operational risk where banks should be attempting to estimate the level of loss that they are expecting for next year. That is quite different to the cost centre accounting that they seem to be undertaking. I could go on – but the concerns are clear. The modelling is not only inconsistent between risk types it is actually weak in most areas. The consequence of this is that there must be less reliance placed on models by the Risk Department, Board and of course the CRO. There is a need to a return to true risk management.

The Perfect CRO
The perfect CRO needs to have the trust of their Board and have the ability to interpret, explain and act. They need to have equal knowledge of all risk types and of accounting so that they can appreciate the impact on actual results. They need to understand compliance and mathematical modelling which needs to be combined with detailed knowledge of the industry in which they are working.

They need to be motivational in terms of their own team, the Board and the business to ensure that the risk culture and solutions are both embedded and effective. They need to be a good communicator, delegator and prioritisor. Basically they need to be superman. Any takers?

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What Makes a Chief Risk Officer Great!

Global Risk Update 2012 – August
Making Enterprise Risk Management a Reality

Many firms claim to have enterprise risk management frameworks, yet many have had problems with implementation and project effectiveness. In this article we consider the barriers to the implementation of an effective framework, some of the challenges and some of the solutions that should be considered.

**Why Enterprise Risk Management Frameworks Fail to Deliver**

1. **Lack of Senior Management Support**
   It is hard for Boards and senior managers to actively engage in this process. Many start with good intentions which result in the acquisition of an experienced and potentially effective team. However the Board members themselves have a range of responsibilities many of which fall within their normal levels of knowledge and experience. On the basis that you do not “buy a dog and bark yourself” they increasingly rely on the appointed experts and slowly disengage from the process.

   Their lack of knowledge of the area results in their ceasing to conduct the level of review of key elements of the programme that is required which is increasingly perceived as their having limited interest in the ultimate success of the project. Developing an Enterprise Risk Management Framework is a major change project and requires maintenance of momentum and the availability of critical resources. In the absence of evidential key management support it can be hard to identify this as a key project receiving the necessary level of support required for its success from the business.

   Of course some Boards do include the necessary skills, but these are not always evident in all firms. The failure to appoint particularly non-executive directors who have real knowledge and experience of risk management has certainly exacerbated this problem. Training for Boards and senior managers combined with the appointment of additional non-executive directors with risk management skills would certainly start the process. Regular reporting on the project from the Board to the business would also assist in ensuring momentum is maintained.

2. **The Risk Management Team are Seen as Outsiders**
   Many of the staff recruited to staff the risk management function will come from outside of the organisation with knowledge of risk management techniques applied in their previous firms. They could be seen as a regulatory imposition by the business that fails to appreciate their value or their role.

   Some of the teams are themselves the cause of the problem. They seek to show that they are the experts in the field operating with the business on a “needs to know” basis. They resort to jargon as a form of protection and to attempt to garner respect and develop a mystique. This only serves to exacerbate what is seen as a “them or us” approach.

   Some of these teams will have combined experience of one or more approaches. Enterprise
Risk Management is not new, yet many of the techniques we are currently implementing are often perceived as being new when this is not the case. However the expertise hired from outside may bring their previous approaches to your firm when they are not suitable. They could be over complex, more expensive than necessary or totally inappropriate for your type of business. Of course unless the senior management have some form of awareness of what they are looking for then how could they identify that an approach was inappropriate?

To counter this we would expect the Risk Management team to include a number of staff who have been with the firm for a period of time and bring knowledge of “how we do things around here” to the team. This needs to be supplemented by regular reviews of the project by knowledgeable experienced external experts to ensure the project is not going off track.

### 3. Systems are Acquired to solve a Data Problem

I am sure that we have all seen this issue in practice. A firm knows it has a paucity of data so believes incorrectly that a systems solution will solve the issue. It may be that the risk management team have familiarity and respect for systems that they have used before which are data hungry but potentially effective risk management systems.

The acquisition of such a system actually has the effect of delaying the firm dealing with their real issue which is the data availability. Often the data exists but either is not easily sourced or can only be sourced at an exorbitant or prohibitive cost. Having acquired what is then the wrong system to deal with the wrong problem, the risk management team are indelibly wed to its ultimate success. Rather than dealing with the data issue they seek to develop synthetic data solutions which nobody understands or believes. The outputs from such a system are likely to be at best inaccurate and at worst misleading.

To counter this, the initial project plan should identify the key data requirements and any barriers to an effective implementation. The software solutions identified as meeting the needs of the firm should be consistent with the actual needs of the firm and consistent with data availability. If there is a data issue this should be identified and dealt with first perhaps by using the services of one of the outsourced service providers.

### 4. Risk Management is seen as a Regulatory Construct

In some firms it appears that the only reason risk management is being implemented is due to pressure from the regulators. Whilst anything that ultimately results in a risk management framework being completely implemented must be welcomed, risk management is a not a regulatory requirement. The business needs effective risk management regardless of the regulatory requirements.

The problem is often caused by the way that the project and its development are communicated to the Business. If the regulatory stick is used to liberally then the entire project is seen as being really a compliance issue and the Business essentially disengages, leaving everything to the risk management professionals to deal with. You hear comments such as “Risk is management by the Risk Management function” or “We only do that because we are told to” without any of the values of the project being clear.

This should have been avoided and communication is at the heart of the matter. In all communications both from the senior management and from the risk management team should emphasise values and drivers, making the programme part of the way we do business as opposed to an imposition. If you have to rely on regulation to make the programme tick then you have probably lost the argument and will find barriers to meeting the use test.

### 5. Failing the Use Test

Even the regulations include the need for risk management data to be used by the Business. Essentially an enterprise risk management framework has the objective of ensuring that risk assessment and evaluation are included throughout the firm, from the Chairman to the Doorman. Of course not everyone requires the same risk management data nor are they able to make use of it in the same way. Much of this is about education so that the business has a better idea of what it should need as opposed to what it currently gets. It is also about constructive challenge by helpful risk management professionals that are patently adding value.

If modelling is too complex the ability of the business to understand and appreciate the outcomes could be impaired, limiting its usability. If the risk management function move from facilitation mode to taking direct responsibility without values being clear then the likelihood of the data being used is small. Of course effective risk management is not just about calculation, rather it is a state of mind. What is needed is for all staff to consider risks and risk mitigation as they are conducting their roles without confusing risk reward relationships.

### 6. Undue Complexity

All risk management units will need to undertake some form of risk modelling, using some elements of complex mathematical techniques. However in some teams this appears to be all that they do – what they are forgetting to do is risk management. To get senior management and Business buy in the risk professionals will need to translate the mathematics into a form that is understandable to the people that need to use it. In other words avoid equations if your audience cannot understand equations!

There is an intellectual challenge for risk management professionals to make complex ideas simple and to seek simple as opposed to elegantly esoteric solutions where these exist. If the output is unlikely to be completely accurate or is intended to operate on average or over pools then there could be simpler attribute based solutions which could be applied.

It is also important for both senior management and the Business to be willing to state clearly that they do not understand the modelling. If they do not have the right level of knowledge then they will not know the limitations of the
technique or the assumptions that have been made. Without this knowledge the data could be dangerous for them to use. Adequate challenge in the Risk Management Committee should resolve this issue.

7. The Wrong People on the Risk Management Committee

Who should attend the Risk Management Committee? If it is the risk team headed by the Chief Risk Officer then it is an internal departmental committee and not really a true Risk Committee. If it is only the Board then the meeting could end up replicating discussions that should (and are) conducted at the Board. Neither feels appropriate.

Since Enterprise Risk Management is a Business concern it is the business that should be represented and dealing with the issues, facilitated by Risk Management. This would suggest that business units should be represented with the C Suite only taking responsibility where the business would not otherwise be represented. The Chief Risk Officer is then the secretary to the committee as opposed to the Chairman of the Committee. The Risk department do not own risk. They neither enter into transactions nor develop business. Their role is to ensure that the business manages to do this effectively. It is when this role is not clearly understood that so many problems occur.

8. Inconsistent Modelling

At its heart Enterprise Risk Management needs consistent modelling across the business. This needs to be conducted in each of the silos of risk that currently exist. If there is a clear risk vision as to what the framework is intended to achieve then this helps. Developing a single risk taxonomy with each risk terms defined only once in a language that mere mortals could understand would obviously help. Implementing thorough risk appetite modelling together with a risk acceptance policy dealing with the correlation of risks and cascading this to the level of the control would also be of benefit.

Within the risk silos (credit, counterparty credit, market, liquidity, operational, reputational and strategic) there is a need for tactical and strategic risk solutions. The tactical involves the business to achieve the modelling that they require for their own purposes. This may not be completely identical for all risk types although consistency where appropriate would be an advantage.

They also need to consider strategic enterprise risk management which requires that the total output from the framework is actually additive. This again is about vision and understanding that tactical and strategic risk management may use the same data as input but could actually be difficult. While some level of differentiation is appropriate for tactical risk management, this cannot be applied to strategic risk management.

In Conclusion

So there are a range of issues which cause the programme to fail to achieve its objectives. Some of these are risk management’s fault while others are due to over exuberant expectations or a lack of knowledge. Each can be addressed with care and thought. An effective Enterprise Risk Management Framework enables a firm to better understand and price the risks it is taking improving profitability and reducing earnings volatility. Surely that is a worthwhile objective for any firm!!!

For comments and feedback

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APRM Risk Management Certificate and Training

This learning programme is at an introductory to intermediate level designed to expose candidates to the key components of risk management and provide practical examples and tools. This classroom course is designed to provide a broad overview of risk management for the financial services sector from experienced Risk Reward risk management professionals who offer essential, practical advice gained in international financial markets and major institutions.

At the end of this course delegates will gain an understanding of:

- Familiarity with the concept of risk management and its place in the business, organisation or system;
- Concepts of risk management techniques in a non-quantitative framework; How 'governance' fits into the concept of risk management;
- The concepts of risk and return; familiarity with the financial instruments used in risk management;
- Interest rate risk and hedging; Asset-liability management;
- Enterprise, Credit, Market, Liquidity and Operational Risk Management;
- How performance can be measured; Industry standards and best practices of financial risk management;
- The positive role that risk management can play.

Chartered Institute for Securities & Investment (CISI)

Formed in 1992 by London Stock Exchange practitioners, the CISI now has more than 40,000 members in 89 countries. More than 40,000 examinations have been sat in 49 countries, covering a range of vocational qualifications. Increasingly regulators, banks, stock exchanges, and brokerage houses are seeking qualifications among to deal effectively with stresses and pressures to maintain high levels of professionalism, integrity and competence especially when interacting with retail consumers. Training to internationally recognised and respected standards is among those responses, whether seasoned professionals, recent market entrants or new graduates.

The CISI is the UK’s largest and most widely respected professional body for the Securities and Investment industry. CISI Diplomas and Certificates are included in the UK’s Financial Services Skills Council’s list of Appropriate Examinations and are recognised for all major activities.

For more information about training to PRMIA or CISI qualifications, certificates and Diplomas or to book or ask for an in-house quote please email Sivanti Martin at SM@riskrewardlimited.com or tel +44 (0) 20 7638 5558. www.riskrewardlimited.com/public-course-calendar
The Spanish Banking Sector: Where to Now?

In this article, Dennis Cox, CEO, Risk Reward Ltd together with Alexander Brown discuss the continuing crisis in Spanish banking. They review both the economic and political background and identify a series of options which should have been considered to resolve the situation.

The Current Scenario

The collapse of Bankia in May of this year and the subsequent uncertainty in the Spanish banking sector has left both Spain and its fellow Eurozone members reeling as Mariano Rajoy’s government is left scrambling for a solution to attempt to save its financial sector.

Following the request by BFA, Bankia’s parent group, for a public bailout of €19 billion on top of a previous government cash injection of €4.5 billion, it quickly became clear to the global markets that Spain did not have the liquidity to finance such a move and would have to turn to foreign aid.

Now, with over €97 billion worth of savings and investment having left the country in the first quarter of 2012 and another estimated €180 billion worth of toxic loans derived from a stagnant property industry tied up on the balance sheets of Spain’s national banks, obvious parallels can be drawn between the Spanish crisis and that seen in Ireland in 2009. Clear and decisive action is necessary on the part of the Spanish government to help try to restore international confidence in the banking sector.

As the situation currently stands Rajoy’s Partido Popular has three possible options before them:

1. Recapitalising or nationalising parts of the Spanish banking system,
2. Allowing ailing banks to fail and letting insolvency regulation take its course (with a deposit protection scheme securing the first €100,000 held by an individual in a savings institution), or
3. Creating a Spanish version of Ireland’s NAMA, the so called “bad bank”.

Any option will require some funding from Brussels either through the EFSF or the ESM. However there are difficulties in obtaining the necessary consensus leading to an effective capital saving. Spain is a much larger economy than Greece or even Ireland, which received a €78 billion bailout, and the size of funding requirements may prove prohibitive.

The recently announced €100bn Euro bail out will not in our opinion be sufficient to provide anything other than short term relief for the Spanish banking sector. Further, there are doubts regarding its funding. Lastly, that the German government retains the view that providing additional capital would only encourage profligacy inhibits unity action. Generally Berlin opposes further moves for bailouts by Eurozone members without submitting a combined EU and IMF austerity programme which would potentially further cripple the economy and be politically humiliating for Spain’s new government. Austerity without growth prospects and hope inevitably leads to depression and civil unrest.

The Economic and Banking Reality

Fundamental to any support from Brussels, however, are the results on the Spanish banking sector due to be released over the coming months. The IMF is due to publish a complete report on the Spanish Banking sector next week. On top of this Spain has hired the ‘Big Four’ accountancy firms to audit the entire Spanish banking sector, with results expected some time in August. The Spanish Ministry of Economy and Finance have hired two consultancy firms, Roland Berger and Oliver Wyman to run stress-tests based upon the methodology of those run last year by the European Banking Authority with results due in the next two months. This is all likely to result in a continual barrage of bad news facing the Spanish Banks and banking market further reducing the likelihood of any economic action taken. It will also require additional bail outs to be provided the size of which will probably have been increased by the recent funding requests.

With the interest costs on Spain’s 10 year bonds having risen above 7% last week, indecisiveness or floundering would only lead to further loss of international confidence in Spain leaving it frozen out of the credit markets.

However on June 7th Spain successfully sold 2 billion worth of 2yr, 4yr and 10yr bonds at a yield of 6.40%
in the primary debt market and cover of over 3.5 times the debt sold. Are they frozen out the debt market, is confidence in Spanish government bonds rising or were sales driven by speculation? Without clear and decisive action, Spain faces further collapse in the economy as its banking sector crumbles and investors flee the country towards its safer and more stable northern neighbours.

Confidence in the international market is dependent upon political and economic stability, investors must feel that the political system and regime are stable, with a foreign policy that is positive to foreign investment and an economy that is growing sustainably to encourage long term investment. The bursting of a large property bubble in 2008, an industry which contributed to 12% of GDP and employed 20% of the Spanish workforce, led to a collapse in economic growth, raising government debt without an alternative industry to drive the growth necessary to rehabilitate the Spanish economy. Moreover Spain suffers from a new and inexperienced government which won a landslide victory on the back of resentment towards the Partido Socialista Obrero (PSOE) previously in power. (It can be said that this result was far more a rejection of the left-wing Partido Socialista (PSOE) than a huge support of Rajoy’s conservative Partido Popular.) As such this is a ministry that has yet to cut its teeth on any political crisis, which has shown in its scattered early approach to the banking crisis so far and its initial failure to achieve any real resolution with Brussels. The recent €100 billion bailout proposals do appear to show recognition of the seriousness of the situation. The real question however is how the Spanish electorate will react to this problem, will the government manage to keep its electoral pledges and will we see outbreaks of civil unrest and disobedience in the autumn of this year?

A Nation of Nations

The political system in Spain is predominantly bi-partisan with the two main parties being el Partido Socialista Obrero de España (the Socialist Worker’s Party of Spain), which was voted out of power in November 2011 having been in power from March 2004 following the political fallout in wake of the Madrid bombings, and el Partido Popular whose leader, Mariano Rajoy, is the current Prime Minister. Beyond these two parties exist a number of smaller, minority parties representing some autonomous regions of Spain, in particular Cataluña, Galicia and El País Vasco. The Executive, (the Spanish government), is bi-cameral with a Congress of Deputies and a Senate, both elected which have control over federal policy.

The Judiciary consists of a Supreme Court exercising jurisdiction over national and provincial courts and a Constitutional Court which concerns itself with matters of constitution and human rights issues. Spain is, to quote American author Walt Whitman, ‘not merely a nation but a teeming nation of nations’, composed of 17 autonomous communities and 2 autonomous cities with 6 official dialects and 3 other large unofficial ones.

Unified in 1469, the country was previously made up of smaller kingdoms before an alliance between Aragón and Castilla formed Hispania, encompassing a large proportion of what is now considered modern day Spain. Following the transition to democracy in 1979 the boundaries of the autonomous states were redrawn and provisions were made within the constitution for the devolution of power to these individual states, each with their own executive and judiciary powers and far more importantly fiscal independence. Each autonomous region has the right to set its own budget and spending which causes a major problem for Rajoy’s government. The autonomous communities seek the best of both worlds, fiscal independence coupled with security from the central government in bailing them out should things go horribly wrong. Another problem facing Spain’s federal government is nationalism and sovereignty. There exists a strong basis for the argument of Spain as a multinational State and demands for sovereignty are particularly strong in the communities of Cataluña, Galicia and el País Vasco. Most notorious in the fight for sovereignty is the Basque separatist terrorist organisation ETA who since 1968 killed 829 individuals.
and injured many others, although never actively targeting civilians directly. Hindered by the toughening anti-terror laws and international cooperation in the wake of 9/11, ETA nevertheless is still a threat to political stability. Although under cease-fire as of September 2010, this may be merely a convenience for them and on previous occasions they have broken the ceasefire when it was to their advantage.

Whilst no terrorist activities have been claimed by ETA since June 2009 members of the Spanish gendarmerie ‘La Guardia Civil’ were injured following a spate of terrorist activity throughout that year. The government must balance on a knife-edge here, reining in the spending of autonomous regions to comply with the Maastricht Treaty without engendering any strong anti-government pro-sovereignty feeling which would weaken the current government and would risk a breaking by ETA of the ceasefire on the back of these anti-federation feelings. This would cause political turmoil the like of which would frighten off potential investors.

Worth considering is the growing feeling of ‘Euro scepticism’ within Spain. Spain is only 1 of seven countries in the European Union to not have an outright Eurosceptical party. However at this time there is a growing sense that the European Union is somewhat of a lost cause. Renowned Spanish economist José Luis Sampedro argues that Europe is not and will never be united since unification would take widespread agreement and also that the centralised control it would necessitate would weaken the existing tired capitalist system in Europe as competition and entrepreneurship is hindered by bureaucratic red tape.

It was Spain’s membership of the Euro which allowed the opportunity for the creation of a property bubble and without a separate peseta to allow for devaluation against other European currencies and J-curve analysis to hold true, its unit labour costs have soared over 40% and left its exports uncompetitive. There is certainly evidence to suggest that Spain’s non-participation in the Eurozone is being considered within the Congress of Deputies. Although at this juncture it seems unlikely that Spain will leave the Euro in the short term its impact on the long term success of the Spanish economy will continue to result in increasing pressure to withdraw with the forthcoming Greek election it is likely that either a radical Greek government might come into power or no government will be able to be formed. Either option will cause increasing chaos within the Eurozone and will cause increasing problems for Spain as a consequence.

**Trickle-up Change**

In terms of civil unrest, the main civil political movement at this time is ‘15M’, which started as a random outburst of smouldering public resentment with an unplanned sit-in at the star-shaped traffic intersection, la Puerta del Sol, in Madrid on May 15 2011 but has since taken the shape of a revolution of the intelligencia in Spain, with clear aims, pamphlets and supporting literature and a peaceful base now permanently maintained in the Puerta del Sol. The movement is driven by Utilitarian ideals that society should be driven by will to do the greatest good and cause the greatest happiness for the greatest number of people with harming the autonomy and rights of the individual.

A key pillar of this ideology is that the government, like the banking sector, have lost sight of their purpose which in a representative democracy would be that of protecting the interest of their voters. Instead the argument goes that the short-termism nature of politics means that politicians are driven by what will gain them funding for electoral success, and a widespread support base, and that break from short-termism is necessary for any real economic progress is to be made in Spain.

The current banking crisis has given rise to a new wave of negative feelings with slogans like ‘Para la banca SI hay dinero, para sanidad y educacion NO’ (Translation: There’s money for the banks but not for Health and Education). Similarly it feels that the banking sector has lost sight of its true purpose which is to facilitate economic process. The earliest forms of banking, whilst no doubt profit driven, were engaged in agriculture and trade at a time when agriculture was seasonal and transportation took months, not hours or days. For example, banks would finance trade and farming, and merchant banks issued 90 day credit for travellers on the Silk Road, and ultimately held savings.

This is a view held by Joseph Stiglitz, the Nobel Prize- winning economist who in a speech to the Carnegie Council in September 2009 argued that the economic crisis was due to banks failing to serve their intended purpose ‘which is allocate capital, manage risk, and do it at low transaction cost.’ The claim is that the financial sector has gone from a sector which aids the economy to a huge industry in its own right driven towards profit-motivation rather than the quality of service provision. The extent of the effect which 15M will have upon the current system in Spain is difficult to predict. Whilst it will certainly be an influence it is doubtful they will achieve the full-scale revolution which they seek. Political upheaval is unlikely but change will definitely be forthcoming.

**Retail Banks and Cajas**

The Spanish banking sector is divided into two main parts, large international retail banks such as Banco Santander and BBVA and smaller regional savings banks called ‘cajas’ (‘caixa’ in Catalan and Galician). It is these ‘cajas’ that are worst affected by the current financial crisis in Spain, the Spanish property bubble caused them to encumber themselves with large amounts of now ‘toxic’ assets made up of real estate loans or repossessed properties in a falling property market. Spain’s premier anti-foreclosure organization, the Platform of People Affected by Mortgage (PAH) claims 150+ evictions occur daily, whilst statistics released by the INE (Instituto Nacional de Estadisticas) show that...
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over 5.6 million houses, 20% of all homes in Spain, lie empty with Spanish property prices having fallen 30% thus far from peak to the present.

The cajas’ small size means that they have little capital of their own, which was not a problem during the economic boom of the early part of the 2000s as credit was plentiful and free-flowing. With the economic crisis of 2008 they have had insufficient capital to be able to survive on their own and so have attempted to merge. The question is do these mergers result in a sustainable and feasible business model? It is questionable whether it would make sense to create larger financial institutions whose combined assets are still concentrated in toxic property. Does this risk creating institution which fall under the umbrella of those which are ‘too big to fail’ or is this an attempt to gain enough capital to allow for investment in a more diverse bank of assets? The more important question perhaps is whether these institutions will have the liquidity to allow them the time to diversify, minimise their exposure and start to lend again to stimulate interest and investment in the Spanish economy or will these crudely formed leviathans merely crumble?

Crucibles of Cajas

One complication is that these mergers have not been achieved through acquisition of one bank by a larger competitor but instead by forming a crucible, a curious amalgam of cajas of different sizes, taking different levels of controlling interests in the new trading company. Each caja predominantly serves a different province retaining its own histories and traditions. Whilst creating these banking groups, the cajas also maintain their own independent brands and working systems. The issue is that these banks are small regional banks predominantly serving different ‘provincias’ or small provinces based around a major city. Nothing is essentially achieved by such mergers other than increased complexity and confusion.

Let us take Bankia as a case study. Bankia was a merger between 7 of these provincial saving houses, most notably the two largest of which were Caja Madrid and Bancaja. However whilst the assets were merged and a new trading name of ‘Bankia’ was established, the seven institutions maintained their individual brands foregoing most of the potential cost savings and meaning that the merger process was merely time-consuming and inefficient. The bank is believed to hold an estimated €32 billion worth of assets in toxic property loans, a figure worth considering when the bank’s new Chairman, José Ignacio Goirigolzarri, formerly of BBVA, claims that €23 billion is needed for the bank’s recapitalisation. Either of these figures raise the question of quite how deep the pit is into which the bailout would be sinking money to, and whether the hole in Bankia’s books will continue to grow over time.

The other main merger in the last two years was Grupo Banca Civica, which combined four cajas: Caja de Burgos, Cajasol, Caja Canarias and Caja Navarra. This attempted merger has turned ‘bad’ as shares in Grupo Banca Civica have fallen since July 18, 2011 opening at from €2.70 to an all time low of €1.22 on May 28 of this year as the Bankia story broke. This group is currently looking to be incorporated into the Catalonian bank ‘la Caixa’, with 1 Caixa share offered for 5 Grupo shares.

These two mergers seem to have backfired dramatically, but the Caixa merger seems set to go ahead as well as a new merger announced on May 29 between Liberbank, Ibercaja and Cajatres with combined assets of €120 billion with both Liberbank and Cajatres themselves products of earlier mergers. Past experience has shown that merging of cajas does not succeed because it is too slow and ineffective as a process and even once completed the merging cajas do not have the necessary strength or capital to survive the stress and strain that the current economic conditions places upon them. It is almost as if the Spanish banking sector does not want to learn from experience. The Spanish government and banking sector must find a new approach. Where can they go from here?

Option 1: Recapitalising the Sector

The first option available to the current Spanish government is to recapitalise the Spanish banking sector. This is the approach the Spanish government is trying to take, calling actively and explicitly for intervention and aid from European institutions to provide the necessary capital to finance such a move. This follows Spain’s budget minister Cristóbal Montoro’s statement that the rising interest on government debt means that Madrid ‘does not have the door to the market open.’ He also said on Spanish radio station Onda Cero that we have a problem in accessing markets, when we need to refinance our debt.’ However this could be part of an attempt by the Spanish prime minister, Mariano Rajoy, to force Brussels’ hand into accepting a banking union and backing Eurobonds (following opposition to the idea by Berlin with some positive interest for the idea in Paris.)

A major problem with this approach is the scale of the package necessary to recapitalise the Spanish banks. Montoro claims that ‘we’re not talking astronomical figures’ with Banco Santander CEO Emilio Botín claiming that €40 billion are necessary to recapitalise the four nationalised banks: Bankia, Caixa Catalunya, Navagalicia and Banco de Valencia. However as previously stated over €97 billion have left the country in the first quarter of 2012, compared with an inflow of some €20 billion over the same period in 2011 and with an estimated €60 billion leaving in March alone. The speed at which savings are leaving the country is accelerating.

This is without the figures for the first two months of the second quarter which will show even worse results. As such it seems that the cost of recapitalisation may be greater, with our estimate lying somewhere in the region of €200 billion, much harder figure to raise. If recapitalisation of one bank requires in excess of €40 billion (probably €70 billion) then the sector probably requires €200 billion. It will also require liquidity of an excess of €150 billion once the trend of cash withdrawals will have significantly increased over time. Recapitalisation is possible but will be both expensive and as discussed politically difficult to achieve both locally and in an EU context. The alternative of nationalising the entire
banking sector could actually fail by default. If the banks continue to fail then nationalisation may become the only viable alternative, solving nothing

The possibility of recapitalisation is at this time a distant one, with agreement needing to come from at least the Eurozone countries, which number 17 (or the entire European Union of 27) that are highly unlikely to agree. With the current situation appearing to be down to the wire, the result from such an approach is too distant for the floundering Spain to wait on. Hence this option for the time being is unlikely and should be ruled out.

Option 2: Allowing Banks to Fail

Deposit protection currently in Spain is up to €100,000 for credit institutions. A possible option left open to the Partido Popular is to allow insolvency to take its course. In fact measures to speed up the insolvency process and facilitate pre-insolvency restructuring and refinancing were made by the PSOE in September 2011. This is by and large the most austere of the options available to the current ministry and would be difficult to reconcile politically with the Spanish people. Externally however, it is worth noting that the only one Spanish financial institution on the SIPI list (the list of Structurally Important Financial Institutions, or banking institutions that are structurally important globally and cannot be allowed to fail) is Banco Santander. From a global perspective therefore there is little issue with allowing insolvent banks to merely fail.

Allowing local cajas to fail will do nothing to foment the sense of nationalism which Rajoy’s ministry needs to ease Spain’s course through this economic storm. The second issue which arises is the cost of deposit protection which the government would have to bear. Even considering the vast amount of savings leaving the country over the previous months, Spain would need to seek outside aid to provide the capital necessary to finance this option.

The benefit of this option is that it removes the argument that financial bailout could not be justified to ‘moral hazard’, taking undue risk since there is no accountability. There is a great deal of public support within Spain for this approach, with strong backing from the aforementioned 15M movement who are lobbying for a protection of the depositors rather than the institution. In reaction to the existing Bankia crisis, 15M published a manifesto pushing for the accountability of banks for their actions rather than allowing ‘moral hazard’ to occur.

There is no logic in saving a bank unless the loss of the institution would cause significant economic stress. In terms of the savings banks, the failure could further depress an already struggling retail housing market in a specific region due to increased foreclosures. However there is not likely to be any long term fall out and depositors would be protected by the deposit protection scheme. Normal insolvency procedures would operate efficiently and depositors would receive the insured part of their deposits then migrating to higher quality names. This does appear a viable or relatively low risk alternative.

Option 3: The NAMA Solution

When considering the financial crisis in Spain it is worthwhile drawing comparisons between the crises that has arisen in 2008 in Ireland and now Spain. The Celtic Tiger economic growth over the last decade was driven by a property bubble, although a technological revolution also helped to drive the surge in Gross Domestic Product. Ireland’s growth had been over +10% change in Gross Domestic Product for the ten years preceding the financial credit crisis. It too at first attempted the nationalisation of banks taking controlling interests in Anglo-Irish Bank with both Allied Irish Bank (AIB) and Bank of Ireland (BoI) each receiving a €3.5 billion recapitalisation bail-out package.

In the end Ireland created the National Assets Management Agency (NAMA) using a €77 billion budget to purchase ‘bad’ loans and assets from

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banks in the Republic of Ireland which it would then hold and manage for a projected 7 to 10 years. In the short term it recapitalised the Irish banks, and increased confidence in these institutions having less toxic assets on their balance sheets, and in the long term it allowed for the government to attempt to recover finances. The eventual deal involved creating a ‘bad bank’ which contained a mixture of healthy and impaired loans with a concentration on those involving undeveloped land and residential and commercial development. The valuations of those loans were some €90 million and individual loans were required to be over €5 million, an idea supported by the rating firm Moody’s, the purpose being to recapitalise whilst avoiding having to nationalise. The question today is whether such a similar business model could be applied to the Spanish banks. As previously stated Spain’s banking sector is made up of large amounts of mid size savings accounts whereas NAMA took loans only from the 6 biggest lenders. This said, Bankia and the new merger between Liberbank, Cajatres and Ibercaja have created large enough financial institutions to allow for such a deal. The figures for Spanish ‘bad’ assets lie in the estimated region of €180 billion of which Bankia is believed to hold €32 billion and the new three-way merger holds a projected €11 billion.

To enable the banks to thrive one option would be for the Government to create a ‘bank’ to take on the toxic assets as has been achieved in Ireland. The concern is that the banks might return to profligate ways, yet this is a different market with different and more conservative lenders. Accordingly the creation of such a vehicle relying on government guarantees rather than loans would appear attractive. There will still need to be a partial bank recapitalisation but this could be limited to perhaps €70 billion.

**Is the Future Bright?**

Looking forward, what does the future hold for Spain? Regardless of the direction this new Spanish government takes it must act swiftly if it wishes to stay in power and save a dwindling Spanish economy. The critical question remains how is such a revival possible? Key Spanish industries, e.g. tourism, property, automotive and even the wine industry are at best under pressure and are therefore unable to stimulate the growth necessary to rescue the economy. Austerity without vision is a disaster, so unless the current Spanish government can show there is a recovery light at the end of the of economy tunnel, they risk losing power and potential radical overhaul of the existing political and financial system.

With the impact of Germany creating a currency which is inappropriately strong there are few obvious long -term opportunities for Spain to grasp. The initial funding transference of perhaps €200bn will need to be followed by annual transfers of funding in the range of €100bn (indexed) in perpetuity. Will this be politically acceptable remains the question to be answered.

Risk Reward Expert Witness team members provided banking specialists to support the defence of a major commercial property firm against NAMA in Ireland.

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Islamic Finance – an Introduction

There is much to both admire and praise about Islamic Finance. Its stated ethos and principles are probably as close to a model for truly ethical and moral banking as has yet been developed and actually implemented on a large scale.

Based on the Quran, Islamic Finance offers its clients Shari’ah compliant banking but the real meaning and to be fair, the true benefits of this, are often lost on Western observers, some of whom have tended to dismiss the sector as yet another example of fundamentalist religious doctrine applied to real life. But this cynical view is not only undeserved it is also mostly inaccurate. In reality, even a cursory study of Islamic Finance and its guiding principles will confirm it is indeed probably the most successful model for ethical banking to date. But it is not without its weaknesses, not least of which is whether any institution can actually achieve the blueprint and live up to its full potential. The answer is almost certainly “no” but does this detract from its merits?

The whole concept of Shari’ah compliant banking is by Western terms still very much in its infancy. Some conventional banks have been trading for more than 400 years, most for at least 50 and it is often a surprise to many observers that modern Islamic Finance actually started in its present format as recently as 1985. Of course trading and commerce in the Islamic world is actually thousands of years old and pre-dates not only banking but Islam itself. The remarkable legacy of this ancient history is that the basic trading contracts have been refined over millennia and still survive, still work (in the main) and still underpin Islamic Finance.

The guiding principle of Islamic Finance is to provide banking and financial services which are compliant with Shari’ah. Shari’ah is the Divine Law as revealed in the Quran (Book of Allah SWT) and Sunnah (words or acts) of His Prophet Muhammad (PBUH).

The primary authority for Shari’ah is the Quran which means “the text of God” and is actually a blueprint for running a society with detailed rules covering every aspect of a Muslim’s life including religious, family, community and of course trading obligations. It stresses fairness, honesty, integrity and morality to all, even towards non-believers, which comes as a surprise to some people.

The next is the Sunnah which means “well known path”. It covers the words, acts and tacit approvals of the Prophet (PBUH) as recorded at the time and subsequently and includes the Sayings (Hadith) which He used to lay down the law and give moral guidance.

Next comes Ijmā (consensus/agreement) under which suitably qualified Islamic Scholars or Jurists are asked to rule on points of Shari’ah law where the answer is not immediately available from the two senior sources. Then follows Qiyas or “analogy”, which extends the law by applying...
Islamic Finance – an Introduction

- There can be no speculation or gambling.
- No trade in activities or products considered Haram or un-Islamic.
- There must be no trade in pork, alcohol, armaments, pornography, etc.

The most significant basic rule and the one that perhaps most defines the ethos of Islamic Finance, is that all commerce must involve the real sharing of both profits and losses so that all parties, including the bank, have a real and tangible stake in the outcome of the transaction being undertaken. Consequently, and unlike a conventional bank which does, an Islamic Bank does not have a debtor or creditor relationship with its depositors and customers.

The key difference between Islamic "investors" and the "depositors" in a conventional bank is that Islam ic banks are actually investors, all of whom agree to invest alongside or via the Islamic bank as trading partners and are given a profit (and loss!) sharing share based on the term, purpose, maturity, etc of the investment.

The actual investor accounts are based on the ancient contracts of Amanah, Wikala, Wadia, Mudaraba and Musharaka but are generally also reported as current accounts, investment accounts and special investment accounts by many Islamic Banks.

The liquidity challenge in Islamic banks is actually a treasury and profitability problem. There is no effective Islamic inter-bank market and banks cannot lend to or borrow from each other in conventional terms. As a result a bank that finds itself with too many investments or is short of cash, has limited options. The issues posed by this are beyond the scope of this article but typically surplus funds have to be held in low or nil yielding cash form and shortfalls are met by seeking discreet deposits from sovereign departments on a "lender of last resort" basis. This "super tanker" approach to liquidity management will be a real constraint on future growth.

The biggest challenge facing the sector is liquidity but not in quite the same sense that we use when looking at conventional banks. In a conventional bank liquidity is needed to repay depositors and liquidity "difficulties" usually mean the bank cannot meet their withdrawal requests. It is fear that drives this process and usually triggers panic, which in turn starts a wholesale stampede as depositors jostle to get their money out first. Restoring confidence, very quickly, is the only solution, something the authorities failed to do with Northern Rock.

Faced with bank collapses in the West, all Islamic jurisdictions made it clear in unequivocal terms that they stood fully behind the Islamic banks in their territories. As these territories included some of the richest countries in the world, most Islamic investors are now satisfied that the risk of losing their money is minimal. Anecdotal evidence from various institutions suggests investors having seen the worst are now relaxed and no major withdrawals have been reported.

The author welcomes your feedback and comments. MCA@riskrewardlimited.com
The Basel Committee on Banking Supervision (BCBS) published paper 223 entitled The Internal Audit Function in Banks in June 2012. It sets out a series of principles with regard to internal audit which will be of interest to anyone involved in bank internal audit. It will be seen as international best practice by any regulator and generally sets out the approach that should be taken with regard to internal audit. There are some challenges for firms within some of these requirements, although many firms may already comply with the majority of the principles.

In terms of the international nature of regulation, the committee that developed these principles included three representatives from regulators in the USA, as well as representatives from Europe, Japan and Canada; so clearly there is international support. The document replaces the 2001 document Internal audit in banks and the supervisor’s relationship with auditors. It takes into account developments in supervisory practices and in banking organisations and incorporates lessons drawn from the recent financial crisis.

Key Objectives
The paper states that a strong internal control system, including an independent and effective internal audit function, is part of sound corporate governance. It requires that banking supervisors must be satisfied as to the effectiveness of a bank’s internal audit function, that policies and practices are followed and that management takes appropriate and timely corrective action in response to internal control weaknesses identified by internal auditors. The paper notes that an internal audit function provides vital assurance to a bank’s board of directors and senior management (and bank supervisors) as to the quality of the bank’s internal control system. In doing so, the function helps reduce the risk of loss and reputational damage to the bank. It is clear from recent lapses in bank controls that internal audit will be under even greater scrutiny and therefore the requirements of this paper will need to be clearly addressed by bank and their internal audit functions.

We will address each of the principles in turn.

Supervisory expectations relevant to the internal audit function
Principle 1: An effective internal audit function provides independent assurance to the board of directors and senior management on the quality and effectiveness of a bank’s internal control, risk management and governance systems and processes, thereby helping the board and senior management protect their organisation and its reputation.

The requirement is that the internal audit function should develop an independent and informed view of the risks faced by the bank based on their access to all bank records and data, their enquiries, and their professional competence. Notice that this includes all bank records and data. I have become increasingly concerned that some internal audit functions limit their work to areas which fall below governance, for example. It is clear from this principle that the expectation is that all areas will be addressed.

The requirements also state that the internal audit function should be able to discuss their views, findings and conclusions directly with the audit committee and the board of directors, thereby helping the board to oversee senior management. This is generally what we see occurring in practice. Notice that the requirements do not explicitly refer to the senior non-executive director role.

(a) Independence and objectivity
Principle 2: The bank’s internal audit function must be independent of the audited activities, which requires the internal audit function to have sufficient standing and authority within the bank, thereby enabling internal auditors to carry out their assignments with objectivity.

This appears to be a requirement that firms would always comply with. However within the detail there are a
couple of matters worthy of attention.

The paper states that:
“the internal audit function should not be involved in designing, selecting, implementing, or operating specific internal control measures. However, the independence of the internal audit function should not prevent senior management from requesting input from internal audit on matters related to risk and internal controls. Nevertheless, the development and implementation of internal controls should remain the responsibility of management.”

This highlights the problems faced by internal audit when working on the development of systems and controls. It suggests that they should provide their input but neither approve nor be part of the management team for a major change project.

The paper then states:
“Continuously performing similar tasks or routine jobs may negatively affect an individual internal auditor’s capacity for critical judgement because of possible loss of objectivity. It is therefore a sound practice, whenever practicable and without jeopardising competence and expertise, to periodically rotate internal audit staff within the internal audit function. In addition, a bank may rotate staff from other functional areas of the bank to the internal audit function or from the internal audit function to other functional areas of the bank. Staff rotations within the internal audit function and staff rotations to and from the internal audit function should be governed by and conducted in accordance with a sound written policy. The policy should be designed to avoid conflicts of interest, including the observance of an appropriate “cooling-off” period following an individual’s return to the internal audit staff before that individual audits activities in the functional area of the bank where his/her rotation had been served.”

The guidance on cooling off periods is welcomed, but the issue of continuously undertaking tasks leads to the issue of continuous auditing. The concern is that the effectiveness of the auditor is impacted by their being required to undertake repetitive tasks. It is clear that the audit planning process will need to ensure that there is clarity as to the intended goals of the testing conducted and that the approach adopted is such as to provide the required level of effective assurance demanded.

(b) Professional competence and due professional care
Principle 3: Professional competence, including the knowledge and experience of each internal auditor and of internal auditors collectively, is essential to the effectiveness of the bank’s internal audit function.

The rules explicitly state that “The head of internal audit should ensure that the internal audit staff acquires appropriate ongoing training in order to meet the growing technical complexity of banks’ activities and the increasing diversity of tasks that need to be undertaken as a result of the introduction of new products and processes within banks and other developments in the financial sector.”

We would generally expect this to be best achieved through internal training using an external expert providing alignment with the actual requirements of the firm. However there should also be attendance at some external training events to ensure that the firm appreciates the standards being applied by their peers.

(c) Professional ethics
Principle 4: Internal auditors must act with integrity.

This again leads to a discussion of cooling off.

The internal audit charter
Principle 5: Each bank should have an internal audit charter that articulates the purpose, standing and authority of the internal audit function within the bank in a manner that promotes an effective internal audit function as described in Principle 1.

It further states the minimum requirements of the charter as follows:
“27. At a minimum, an internal audit charter should establish:

■ The internal audit function’s standing within the bank, its authority, its responsibilities and its relations with other control functions in a manner that promotes the effectiveness of the function as described in Principle 1 of this guidance;
■ The purpose and scope of the internal audit function;
■ The key features of the internal audit function described under Section A.2 above;
■ The obligation of the internal auditors to communicate the results of their engagements and a description of how and to whom this should be done (reporting line);
■ The criteria for when and how the internal audit function may outsource some of its engagements to external experts;
■ The terms and conditions according to which the internal audit function can be called upon to provide consulting or advisory services or to carry out other special tasks;
■ The responsibility and accountability of the head of internal audit;
■ A requirement to comply with sound internal auditing standards;
■ Procedures for the coordination of the internal audit function with the statutory or external auditor.”
It specifically goes on to state that the internal auditors should have access to management information systems and records and the minutes of all consultative and decision-making bodies. This clearly is intended to include the minutes of the Board.

**Scope of activity**

**Principle 6:** Every activity (including outsourced activities) and every entity of the bank should fall within the overall scope of the internal audit function.

This means that in effect all of the outsourced activities, and their management, are included within the internal audit universe and should be risk assessed.

It also emphasises that the internal audit plan will need to be flexible to deal with changes in the risk profile of the institution.

**Principle 7:** The scope of the internal audit function’s activities should ensure adequate coverage of matters of regulatory interest within the audit plan.

The paper then goes on to specify some of the areas to be covered. It states that "In particular, the internal audit function of a bank should have the capacity to review key risk management functions, regulatory capital adequacy and liquidity control functions, regulatory and internal reporting functions, the regulatory compliance function and the finance function."

Of these it is perhaps the compliance function that provides the auditors with the greatest challenge. To audit this area, auditors will need to have some awareness of the local regulation and also the nature of the challenges that such a function faces. It is essentially auditing an expert, not something that many internal audit functions take on willingly. Of course there are always approaches that can be taken which minimise the need for explicit detailed knowledge, but increasingly regulators are seeking for internal audit to increase their emphasis in such areas.

It then considers risk management and requires a similar level of coverage, stating: “Therefore, internal audit should include in its scope the following aspects of risk management:

- the organisation and mandates of the risk management function including market, credit, liquidity, interest rate, operational, and legal risks;
- evaluation of risk appetite, escalation and reporting of issues and decisions taken by the risk management function;
- the adequacy of risk management systems and processes for identifying, measuring, assessing, controlling, responding to, and reporting on all the risks resulting from the bank’s activities;
- the integrity of the risk management information systems, including the accuracy, reliability and completeness of the data used; and
- the approval and maintenance of pricing models including verification of the consistency, timeliness, independence and reliability of data sources used in such models.”

These are again demanding requirements. By highlighting compliance and risk management, the Bank for International Settlements are requesting that internal audit see these as high risk areas. If the skills to achieve this are not readily available within your team then again external assistance should be sought to supplement the existing team.

They also include work to be conducted on the finance function. It is clearly not acceptable to rely upon the work conducted by external auditors and the expectation is that internal audit will also be active in this area.

The paper states that: “Internal audit should also include in its scope (the list is not intended to be exhaustive):

- The organisation and mandate of the finance function;
- The adequacy and integrity of underlying financial data and finance systems and processes for completely identifying, capturing, measuring and reporting key data such as profit or loss, valuations of financial instruments and impairment allowances;
- The approval and maintenance of pricing models including verification of the consistency, timeliness, independence and reliability of data sources used in such models;
- Controls in place to prevent and detect trading irregularities;
- Balance sheet controls including key reconciliations performed and actions taken (e.g. adjustments).”

**Principle 8:** Each bank should have a permanent internal audit function, which should be structured consistent with Principle 14 when the bank is within a banking group or holding company.

It does go on to state that this will be commensurate with the size and complexity of the organisation.

**Principle 9:** The bank’s board of directors has the ultimate responsibility for ensuring that senior management establishes and maintains an adequate, effective and efficient internal control system and, accordingly, the board should support the internal audit function in discharging its duties effectively.

Two key issues are raised here. Firstly it states that senior management should inform the internal audit function of new developments, initiatives, projects, products and operational changes and ensure that all associated risks, known and anticipated, are identified and communicated at an early stage. Secondly it specifies that senior management should be accountable for ensuring that timely and appropriate actions are taken on all internal audit findings and recommendations.

In some ways it is the second point that is perhaps most telling. If this is moved to the responsibility of senior
management then it is senior management that should do the follow up on audit findings, releasing scarce internal audit resource to identify new problems.

**(c) Responsibilities of the audit committee in relation to the internal audit function**

**Principle 10:** The audit committee, or its equivalent, should oversee the bank’s internal audit function.

Annex 2 to the paper sets out their responsibilities.

**(d) Management of the internal audit department**

**Principle 11:** The head of the internal audit department should be responsible for ensuring that the department complies with sound internal auditing standards and with a relevant code of ethics.

**(e) Reporting lines of the internal audit function**

**Principle 12:** The internal audit function should be accountable to the board, or its audit committee, on all matters related to the performance of its mandate as described in the internal audit charter.

**(f) The relationship between the internal audit, compliance and risk management functions**

**Principle 13:** The internal audit function should independently assess the effectiveness and efficiency of the internal control, risk management and governance systems and processes created by the business units and support functions and provide assurance on these systems and processes.

This is explained by the following table:

<table>
<thead>
<tr>
<th>Line of defence</th>
<th>Examples</th>
<th>Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>First line</td>
<td>Front Office, any client-facing activity</td>
<td>Transaction-based, ongoing</td>
</tr>
<tr>
<td>Second line</td>
<td>Risk Management, Compliance, Legal, Human Resources, Finance, Operations and Technology</td>
<td>Risk-based, ongoing or periodic</td>
</tr>
<tr>
<td>Third line</td>
<td>Internal Audit</td>
<td>Risk-based, periodic</td>
</tr>
</tbody>
</table>

**Internal audit within a group or holding company structure**

**Principle 14:** To facilitate a consistent approach to internal audit across all the banks within a banking organisation, the board of directors of each bank within a banking group or holding company structure should ensure that either:

(i) the bank has its own internal audit function, which should be accountable to the bank’s board and should report to the banking group or holding company’s head of internal audit, or

(ii) the banking group or holding company’s internal audit function performs internal audit activities of sufficient scope at the bank to enable the board to satisfy its fiduciary and legal responsibilities.

**Outsourcing of internal audit activities**

**Principle 15:** Regardless of whether internal audit activities are outsourced, the board of directors remains ultimately responsible for the internal audit function.

So outsourcing of internal audit activities, but not the function, on a limited and targeted basis is allowed. The paper states that this can bring benefits to banks such as access to specialised expertise and knowledge for an internal audit engagement where the expertise is not available within the internal audit function.

The remaining principles relate to supervision as follows.

**Benefits of enhanced communication between the supervisory authority and the internal audit function**

**Principle 16:** Supervisors should have regular communication with the bank’s internal auditors to (i) discuss the risk areas identified by both parties, (ii) understand the risk mitigation measures taken by the bank, and (iii) monitor the bank’s response to weaknesses identified.

**Assessment of the internal audit function**

**Principle 17:** Bank supervisors should regularly assess whether the internal audit function has sufficient standing and authority within the bank and operates according to sound principles.

Actions to be undertaken by the supervisory authority

**Principle 18:** Supervisors should formally report all weaknesses they identify in the internal audit function to the board of directors and require remedial actions.

**Principle 19:** The supervisory authority should consider the impact of its assessment of the internal audit function on its evaluation of the bank’s risk profile and on its own supervisory work.

**Principle 20:** The supervisory authority should be prepared to take informal or formal supervisory actions requiring the board and senior management to remedy any identified deficiencies related to the internal audit function within a specified timeframe and to provide the supervisor with periodic written progress reports.

**What to do Now?**

In conclusion you can see that the BCBS have increased the importance of internal audit within the supervisory framework. All internal audit functions should now undertake a gap analysis against these principles and see where they might be considered deficient. In such cases this should be reported to both the audit committee and the governing committee to enable remedial action to be taken.

This could involve amending the audit plan or improving the depth of knowledge of the audit team. It is also likely to include the identification of suitable resources to assist in complex audits.

The author invites readers comments and feedback

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