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GLOBAL riskupdate

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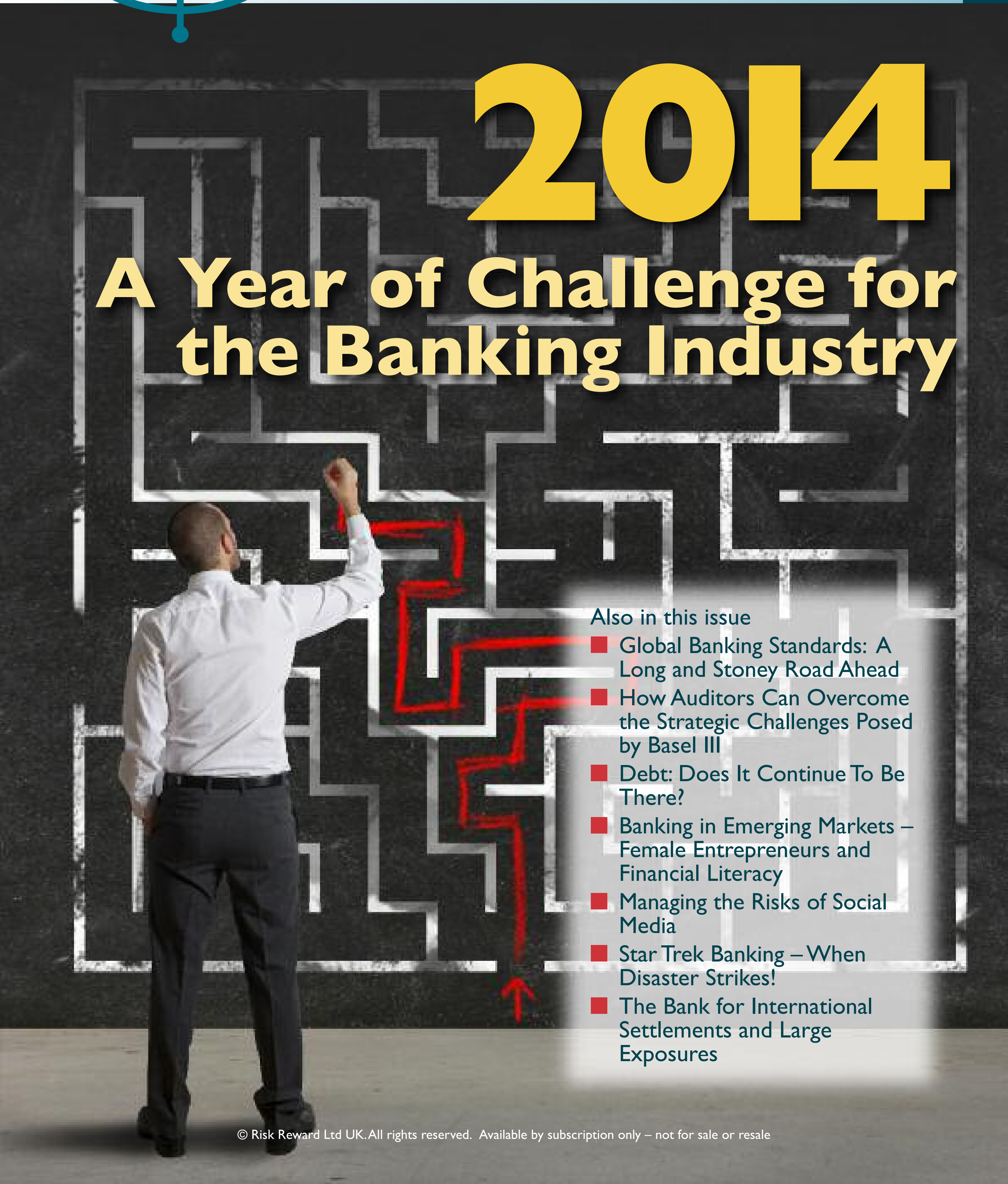

2014
A Year of Challenge for the Banking Industry

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Star Trek Banking... when disaster strikes!

Peter Hughes is a Chartered Accountant, a former banker with JPMorgan Chase and a Visiting Fellow at the Leeds University Business School where he leads research into the convergence of risk and accounting systems. In his article he uses a Star Trek metaphor to illustrate the flaws in conventional risk and accounting systems and the need for a new branch of accounting 'Risk Accounting'. More information on risk accounting is available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2165034

Imagine the US Starship Enterprise flying through space boldly going where no man has gone before. No journey is ever uneventful. Star Trek addicts or 'Trekkies' are all too familiar with scenes of the spaceship suddenly encountering unexpected attacks emanating from alien spaceships or violent atmospheric storms with the crew being helplessly thrown around the bridge. When the crew has made it back to their customary positions the captain demands the inevitable damage assessment. Once that assessment is complete and repairs commissioned attention turns to the spaceship's protective systems. Did the ship's force field and deflectors function as expected and were they effective in limiting impact? Then the captain asks the all-important question... why wasn't there an early warning of the impending disaster?

It's rather like banking

Now imagine a Star Trek episode where, after hitting massive turbulence for whatever reason, the spaceship's steering mechanism fails and the chief engineer has no idea how to fix it. The captain and crew are now faced with a desperate situation. Assuming the steering mechanism cannot be fixed in the short term they will either be lost in space forever or the spaceship may at some point encounter something that its protective force field and deflectors will not be equal to resulting in its destruction. Either way, they are all doomed.

Also like banking. What? Is the global banking system really doomed?

In our Starship Enterprise metaphor, the steering mechanism that failed is accounting. One of the primary purposes of accounting is to present the financial condition of an operating entity at a given point in time so that the board and senior management can monitor progress against strategic objectives and make informed decisions with the aim of enhancing shareholder value. Accounting began to show signs of real stress in the mid-1990s with the advent and subsequent accelerated growth of the derivative. Up to that point the effectiveness of accounting was in its simplicity... a binary transaction recording mechanism comprised of debits and credits. Following a process that has evolved over six centuries (the earliest extant records of double entry accounting date back to the Italians of the Renaissance in the 15th century) accountants determine the debits and credits that represent each transaction and assign them to five buckets... assets, liabilities, income, expense and capital. The difference between income and expense is the firm's profit or loss and when this is added to capital the result is shareholders' equity and reserves which, in turn, represents the net worth of the enterprise. What could be simpler?

This binary form of accounting works if debits and credits and associated exposures are linked. For example, if a bank disburses a loan the debit to the loan account also represents the bank's exposure to the obligor. But if a derivative - let's say a credit default swap - is introduced the amount of economic exposure is delinked from the debit. In this situation the accounting debit becomes merely a numeric record of the amount due from the obligor and the associated economic exposure is transformed into an off balance sheet counterparty exposure. If the credit default swap is then placed into a trading account the counterparty credit exposure is compounded by market risk.

Star Trek Banking... when disaster strikes!

That's a lot for a six centuries old binary recording mechanism to handle. And the truth is, it can't. Indeed, the now rather lame and struggling process of accounting seems only capable of producing audited financial statements that are downright misleading. How can we conclude otherwise when we think back to the financial crisis and all those banks that reported 'healthy' profits followed by a binge-fest of profit distributions in the form of dividends, discretionary bonuses and share buy-backs only to become, months later, the object of taxpayer bail-outs, nationalisations, failures and forced acquisitions? The six centuries old steering mechanism is evidently no longer fit-for-purpose.

We did get an early warning of the increasing frailty of accounting and the likely consequences. The following observation was made almost twenty years ago by economics Nobel laureate Professor Robert Merton:

"Determining appropriate relative comparisons of systemic-risk exposure is the prime measurement issue in the short run. In the longer run… financial accounting needs fundamental revisions and a specialized new branch called 'risk accounting' must be created… Exposure or risk accounting is going to be adapted if we are to have effective external financial accounting and regulation. Current accounting practices are focused on valuation, which is inherently a static measure of financial conditions. Focused on exposures, risk accounting is inherently a dynamic measure of financial condition because it indicates how the individual balance-sheet values are likely to change in response to changes in the underlying financial-economic environment."

Let's return to the US Starship Enterprise with its failed steering mechanism. Super brain Mister Spock has an idea which he is putting to Captain Kirk. He thinks he can figure out a mathematical model that will predict the worst attack the spaceship is likely to suffer as it continues its uncontrolled journey through space. He argues that not only has he stored data relative to the Starship Enterprise's own journeys, but through the United Federation of Planets he also has access to historic data from all journeys undertaken by its members through all known galaxies and it is not unreasonable to assume that, using this data, the model and its outputs will still be valid should they enter new galaxies. Spock's proposition is that all that needs to be done to guarantee survival is to permanently set the spaceship's force fields and deflectors relative to the calculated worst likely attack. Helpfully, Mister Spock adds that his idea comes from a technique developed by 21st century bankers to protect themselves from financial disaster. Captain Kirk declares himself not entirely comfortable with the plan but, with no steering mechanism, it seems to be the only option. His intuition is that there must be something out there somewhere, the like of which they've never seen before, that they will be unable to avoid through evasive action and it will wipe them out. It's merely a question of when that will happen… days from now, months, years, decades… who knows.

The global financial industry must fix its steering mechanism. It is delusionary to believe that accounting based on fair values is capable of providing a fair view of the financial condition of complex financial institutions if the potential future losses attributable to accumulating risk concentrations are not taken into consideration. Such concentrations have grown exponentially since the 1990s as a consequence of IT and operational consolidation through rapidly advancing technology, the widespread use of complex derivative contracts in increasingly sophisticated forms of risk intermediation, the emergence of complex trading and investment structures and the creation of megabanks through successive mergers and acquisitions. Indeed, risk concentrations have achieved a scale that the global financial system will self-destruct if not managed effectively. It is these conditions that became the breeding ground for the new risk foreseen by Merton 'systemic risk' that ultimately triggered the financial crisis of 2007/8 when we stood on the brink of Armageddon.

Mister Spock's formula-based calibration of the spaceship's defence mechanisms is an important component of risk management but it can't substitute for a fully functioning and dependable steering mechanism which must be fixed urgently so that control over the spaceship can be returned to the crew and its navigation systems.

For the global financial system, adapting accounting to meet Professor Merton's risk accounting vision is probably the greatest banking challenge of our age. After all, it cannot be acceptable to regulated financial institutions that they must divert so much of their resources to the maintenance of multiple versions of the same information so that they are positioned to respond to inconsistent regulatory rules and accounting standards. It cannot be acceptable to users of the global financial system and those that invest in it to be presented with audited financial statements based on accounting standards that do not give recognition to all the risks inherent in the transactions financial institutions accept for processing. It cannot be acceptable to boards and senior executives of financial institutions to be presented with financial reports that reflect diverse versions of economic condition and capital driven by accountants' and risk managers' different perspectives of what constitutes exposure and how it should be reported. It cannot be acceptable to regulators that they are unable to observe the build-up of exposure to risk in the global financial system on a complete, consistent and timely basis.

The position is clear... if we fail to fix the spaceship's steering mechanism we are all doomed!

The author invites your comments via email to JK@riskrewardlimited.com

For further information please contact:

Dennis Cox – CEO
telephone: +44 (0)20 7638 5558
email: DWC@riskrewardlimited.com

Lisette Mermod – New York
telephone: 1-917-310-1334
email: LM@riskrewardlimited.com

Joanna Kraska – Public Relations
telephone: +44 (0)20 7638 5558
email: JK@riskrewardlimited.com