In this issue we will again look at the credit crisis from the perspective of risk professionals.

As Risk Reward has been consistently reviewing the causes of the crisis (this is well documented in previous updates) in this update we look at the lessons from the past and their impact on the solutions for today.

It remains our belief that the actions being taken are dealing with symptoms and are actually ignoring what we see as the elephant in the room.

Globally we are seeing governments and central banks seeking to reduce interest rates and increase public spending to stimulate their economies. The question that everyone is now considering is whether this will actually have the desired results. Our views are clear. Since the actions do not deal in any way with the causes of the crisis, but with the symptoms, they will inevitably make matters significantly worse.

Risk Reward has previously explained the crisis dates from 2003/4, not 2007, so any analysis that commences with the latter date will be fundamentally flawed. Further the crisis commenced with concerns over asset securitisation and whether these assets, which have no other significant acquirers, actually can be suitable for the banking book of financial institutions. This is a real problem since the assets were designed to develop AAA rated assets for the banking book to replace sovereign assets and thereby enhance the yield.

The Impact of Reducing Interest Rates

Both the UK and the USA have now reduced interest rates below rates of inflation. The consequences of this are many:

- Anyone with deposits will feel worse off. In real terms their deposits will decline in value and they will consequently wish to reduce their consumption to compensate. Since for every borrower there are typically eight depositors, this has a significant impact on market consumption.
- Companies with significant cash will move their deposits to higher interest rate countries, thereby removing liquidity from the banking sector at exactly the time when it is most required. Such countries include the GCC, for example.

The reduction in interest rates has had a significant impact on the currencies concerned. In the case of sterling we are seeing a reduction of typically 30% against a basket of currencies. This had to be expected. The problem for a country like the UK which imports a significant proportion of
the goods available for sale due to the limited manufacturing base is that it starts to import inflation. With commodities priced in dollars (a 25% depreciation) and the remainder experiencing 30% depreciation, cost inflation is certain to take off at exactly the time when people are feeling times are tough.

Basically the governments take a historic economic model that is effective for an exporting country and applied it to a country that is a net importer. With regret this will have exacerbated the problem as we will see later.

Funding Large Scale Projects

The other issue has been whether countries should commence large infrastructural projects in an effort to stimulate the economy. The problem with such projects is that the type of work uses labour that tends to come from overseas and therefore there is a leakage of cash from the economy. Further these assets are often not income generative and are therefore unable to increase the value of the economy.

There is no evidence that a failure to build was actually the cause of the crisis. Indeed there is a lot of concern at the level of borrowing within the economy. That bank borrowing is in effect being replaced with government borrowing is one of the most surprising outcomes of this entire process. We cannot see any way in which such spending can in any way result in a shortening of the crisis – indeed we are concerned that it may in effect extend the process significantly.

The Actions that Were Actually Required

Perversely perhaps we are of the view that increasing rather than reducing interest rates would have assisted with solving the issues that are of concern. Higher interest rates provide support to the currency and reduce the price of imports. At the same time there is a real rate of return if such rates are higher than inflation, resulting in both individuals and firms placing greater funds on deposit at the banks. This in turn provides additional liquidity within the banking sector and enables the banks to extend credit to other firms – effectively unlocking the credit impasse which we are currently suffering.

One of the concerns that we have had throughout the crisis was the limited experience in their roles of many of the international global players during this crisis. This lack of experience combined with a similarity of outlook and an intention of dealing with symptoms rather than problems has compounded the situation.

It is our belief that eventually sensible people will recognise the actions that must be taken that drives our expectations for next year. It is our view that the actions taken on the UK economy will have extended recession in the UK by at least six months and that such a recession will be far deeper than was in effect necessary.

Do you have urgent and serious risk issues in your organisation you would like to discuss confidentially with a risk management expert before throwing out the Models, expensive Risk Management Software and sacking your Risk Director?

Contact Dennis Cox directly at +44 (20) 7638 5558

What Next for Risk Management?

There is vocal demand for an increase in regulation to deal with the last crisis. Of course that is always the problem – regulation developed to deal with the last crisis can often exacerbate the next crisis.

The first question to consider is whether there was in fact a failure of regulation, and if there was where was it? Previous updates have considered the problems caused by SFAS 157 and IAS 39, so these will not be repeated here. Clearly there is limited back up for the minimum capital requirements for a bank being 8%, with 10% being applied by some countries. At the heart of the issue regarding the appropriateness or otherwise of the regulatory structure is the question as to the role of capital. Historically it was designed to protect the industry from a failure of one institution – in other words were one institution to fail then it would not cause the failure of another institution.

What appears to be being considered is some form of protection to deal with unlikely events, events that might only happen once in a hundred years, for example? The problem about that type of approach is that for ninety nine years out of a hundred there will be a cost to the institution (the capital) whereas in the one year when it is required the capital will be seen to be inadequate. The consequence of this is that if capital cannot protect in normal conditions (when losses are budgeted for, so no capital is required) and it does not work in extreme conditions (when it can never be adequate), then the focus on capital as the measure of risk is probably inappropriate.

We have also seen commentators recommending capital for liquidity risk, together with a requirement for additional reserve lines. Since liquidity is actually the management of capital, providing capital for liquidity risk cannot make sense. We also doubt the value of reserve lines. In the case of a major failure of an institution where significant sums are required would you REALLY expect a bank to send $500m to a stricken competitor in the expectation that they will not get it back? Surely they would take the view that the administrator's could see them in court?
We have a lot of sympathy with the view that the role of regulatory capital as a key measure of risk should be questioned and wonder whether the focus on regulatory capital has itself contributed to the crisis.

Our views remain that stress testing and scenario modelling are of paramount importance to an institution and should lead to action from the Board of the firm.

In 2009 we are expecting to see increased focus on liquidity risk management particularly in the light of the Basel paper issued in November 2008. Since this is likely to be to the detriment of other risk management within institutions, the next crisis will be from a different source. We believe that this will be credit risk where firms utilising the standardised approach in countries where general provisions are not permitted will have insufficient capital to deal with the losses that will actually occur. This is due to the standardised credit risk calibration being based on a QIS undertaken by the BIS in a benign credit environment. We would anticipate that all institutions on the standardised approach would now calculate a lower capital requirement that the equivalent bank using the IRB.

We are also expecting to see a greater focus on enterprise risk management due to the requirement for institutions to understand the totality of their risk environment on a consistent basis. This will involve better and more consistent modelling of risk appetite used as a driver of the risk programme within a firm, linked into stress testing, scenario modelling and economic capital modelling.

The Risk Reward 2009 Predictions

It must be emphasised that these are our views on the next 12 months. These are not in any way a forecast that should be used for trading purposes and we always recommend that you should take independent advice prior to making any investment decisions. We do not accept any responsibility for the accuracy of the materials contained in this section. However many of you will know that we have been quite successful in previous years in reading the market. Together we will see how we do this year.

The real question is are we going to have a downturn or a crash?

Interest Rates

Whilst the short term pressures from what we see as being incorrect government intervention will drive interest rates downward, perhaps to 1%, this is unsustainable. Our expectation is that by the end of the first quarter of 2009 interest rates will have started to rise. We anticipate this to continue throughout 2009 and are extremely concerned at a potential spike in rates during 2010. As at 31 December 2009 we anticipate base rates in the UK being at 4.5% and are concerned that they could double in the following year.

US Dollar Exchange Rates

The unprecedented and unfunded US deficit continues to grow with a series of promises being issued which the US government in our view will be unable to finance long term. This is a serious source of concern and will represent a continual pressure on the US dollar. We see continual weakness against a basket of international currencies including depreciation over the year of around 15%. However there will not be a major change in the exchange rate against sterling as discussed below.

Sterling Exchange Rates

The UK government borrowing is also at a unsustainable level and needs to be taken under control as a matter of urgency. We cannot see any reason for sterling to strengthen against a basket of international currencies and expect a further 20% depreciation. In terms of the dollar the rates will remain at roughly current levels due to the combined weakness of both currencies.

The Oil Price

Last year we forecast that oil would fall within what we still consider to be its natural price band of $40-$60. We can see no reason to change this expectation and therefore continue to believe that the oil price will continually strive to stay within this band. In the short term the removal of the consumption pressures from both the USA and also China/India is having a significant impact and will result in the oil price continually stressing the bottom of the range. At 31 December 2009 a price of around $30 - $40 is to be expected.

Property Prices

Property is falling throughout much of the world. Whether you are considering commercial property in Dubai or residential property in the UK there is nothing that we can see that should cause property prices to rise. The development of infrastructural investments increases the costs of building and the lowering expectations of both companies and people will continue to cause problems for property. Our expectations are a reduction in UK property of 10%-15% and for UK commercial property of 20%-30%. In the case of retail space the fall will be higher – perhaps 35%.

In the US falls will continue, but we expect the largest falls globally to be in Dubai where a 40% fall in commercial property due to the absence of demand is to be expected.

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The lack of trust is compounded by recent public failures will continue to represent a drag on the markets for the foreseeable future. We do not expect a significant rebound during 2009 with markets rising by perhaps only 5% over the entire year.

Bond Markets

The place where you will not want to be in 2009 is in our opinion fixed rate securities. Since interest rates are approaching their bottom you can expect to see fixed rate securities starting to fall. During 2009 a fall in value of perhaps 20% is to be expected on a global basis.

Commodities

As you will have noted we are not very optimistic about assets in general. Some of the brighter spots will be in physical commodities, particularly foodstuffs, which will retain current prices and could experience a small level of growth. Not spectacular but at least they may represent a safe haven in times of stress.

Ponzi Schemes

In the light of current news Ponzi schemes are back in the news.

The question you may be wondering is what actually a Ponzi scheme is and who was Charles Ponzi?

A Ponzi scheme is a technique used by fraudsters where the operator of the scheme promises high return to investors in short-periods but makes no actual investments at all. Instead, the operator will use money from future investors to show previous investors that a profit has been made, paying out sums that actually have not been earned. The scheme is completely reliant upon money coming in from new investors to continue to pay out the returns to existing investors. Effectively the investors who withdraw their funds are actually defrauding the new investors. If the flow of money from new investors ceases, so does that Ponzi scheme.

The scheme is named after Charles Ponzi who in 1919 conducted a scheme involving the buying and selling of international mail coupons. He promised investors a forty percent return in just ninety days. The prospect of high returns within a relatively short period of time is all a part of the attraction that comes with Ponzi schemes. Ponzi was able to take in $1 million within just a three-hour period in 1921. It emerged that he had only in fact purchased $30 worth of mail coupons.

A Ponzi scheme is different to a Pyramid scheme in two significant ways.

Firstly, a Pyramid involves payments being made to an investor on the next level up. In a Ponzi scheme, money is paid directly to the operator of the scheme. Furthermore, the latter can only be sustained by current investors continuously recruiting new investors. A Ponzi scheme does not require new investors necessarily, provided that the operator of it can persuade an existing investor to reinvest his ‘profits’. It is only when the investor withdraws funds that the scheme actually fails.

So the question is how can you identify a potential Ponzi scheme? In the typical scheme returns are higher than the market and normally higher than could be realistically expected from the nature of the activity being conducted. The seller of the investment vehicle is highly credible and normally well connected, such that the regulatory structure either does not apply or loosely applies to the fund.

Finally always remember that if something looks too good to be true then it normally is too good to be true!
In this section we address a series of questions recently asked at Risk Reward training events around the world:

Q: Is there a requirement for a new regulator to consider international bank regulation?

A: This question is being posed by politicians internationally. Of course anyone involved with the banking industry will know that regulatory requirements are set internationally by the Bank for International Settlements. This is a committee of central bank governors tasked with devising suitable global banking regulation.

They have developed the proposition of the Home and Host regulator. The Home regulator is the regulator of the head office and works with a college of regulators (Host regulators) to regulate the international business. One of the strange results of the current crisis is hearing politicians, notably in the UK, recommending the structure that already exists. The real issue is whether the Bank for International Settlements (BIS), based in Basel in Switzerland, has a sufficiently broad remit and the right membership. Since its membership has remained fixed in a post second world war mindset, we would argue that it is not representative of the global banking community.

We would also suggest that central bank governors alone should not be responsible for bank regulation and that other stakeholders should also be involved. The current structure enables theoretical solutions to be applied which may have unfortunate side effects.

Further the BIS are focussed on bank regulation. This crisis has shown that the financial industry operates as one consolidated body including asset managers, insurers, brokers and hedge funds. Accordingly we would recommend extending the scope of the BIS to include the whole industry rather than solely banking.

Q: Is more capital the answer for the banking industry?

A: The original rules that came up with the capital requirements of 8% are now rather old and do not stand up to scrutiny. Some countries actually apply 10% already – but that then leads to the questions as to the objective of capital maintenance.

If capital is to deal with unexpected events, then most of the time it will not be required. Expected losses are deal with best through robust budgeting and pricing strategies and therefore it is unexpected loss that is dealt with through capital. But an averaging style of calculation to deal with events that happen on average can never work effectively. In terms of an unexpected event it will either happen or it will not. One fifth of an event will not happen. Effectively the answer is binary – yes or no.

That means that the capital held will probably never be sufficient to deal with extreme unexpected events – which is why it is held in the first place. To get institutions to hold the maximum capital would put a cost structure in place which would ruin the global economy for the foreseeable future.

Accordingly we have great concerns at the focus on bank capital as being the solution and recommend that instead banks should focus on improved stress testing and scenario modelling.

Q: Are zero interest rates good for an economy?

A: If an economy is a net exporter we view low interest rates as good. The declining currency enables an exporter to grow their markets at the expense of local incumbents. This creates growth in the economy, leading to improved employment and increased revenues for the relevant government.

If the economy is a net importer however, low interest rates are a disaster. The collapse in the currency leads to imported inflation, increasing pressure on local standards of living. Perceived inflation (the inflation felt by people)
is higher than actual inflation and then drives wage inflation.

This is combined with a collapse of government revenue and the withdrawal of industry cash deposits from the banking system. The build up of inflation in the economy forces a change in economic policy by increasing interest rates at the wrong point of the cycle causing massive unemployment. Our concern is that governments are using policies suitable for an exporting country to address the problems of a net importing economy. Such action will generally increase the ferocity and length of the recession in those counties.

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Q: What are the Long Term Prospects for the Banking Industry?

A: This is an issue that we will come back to in future Updates. Our answer to this is that at the end of the crisis there will be a banking industry, but the major players may well be significantly different from those at the start of the crisis. Many of the major players will have either gone altogether or significantly reduced in size. New types of firm will emerge and they are likely to offer different types of service than had previously been the case. The resulting industry may initially be smaller than the industry before the crisis, but you can expect growth to commence almost immediately again. In twenty years a new industry of comparable size with comparable global players will emerge. In terms of the five year view, it is hard to be optimistic. Much of the global action that has taken place has in our view been misguided and exacerbated a difficult situation. It will probably take up to ten years for all of these issues to work through the financial markets, with the borrowing and funding structures representing a long term drag on the economy. What we do expect for new types of ethical transparent instruments to evolve that better meet the demands of the customer base whilst adding value to the international community.

The Problem with Rating Agencies

On December 4, 2008 the Securities and Exchange Commission (SEC) approved a series of measures to improve the transparency and accountability of rating agencies. The importance of this pronouncement is of significance to the global community since the major ratings agencies all have a US base and are therefore required to comply with these regulations.

These proposals were issued for responses within 45 days. Amongst the changes was the following:

“(the rules) would prohibit an (agency) from issuing a credit rating with respect to an obligor or security where the (agency) or an affiliate of the (agency) made recommendations to the obligor or the issuer, underwriter, or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security.”

The structure of the industry has always been a cause for concern to many of us. Ratings are paid for by the company that is rated, therefore ratings agencies actually go about selling ratings. If a company receives a rating that they consider inappropriate then there must be a tendency for them to wish to surrender their ratings. This has been exacerbated by the Basel Accord where banks lending to firms that are unrated receive a lower
capital charge than those lending to firms with poor credit ratings. The surrender of the rating results in a lower capital charge for the bank and also therefore a lower interest charge to the firm.

The ratings agencies also have significant businesses involved with the provision of various consultancy style services. In credit risk Moody’s KMV is one of the market leading credit risk products, whereas Fitch owns Algorithmics, Opvantage and Fitch First, all risk products. The combination of these with consultancy arms means that the ratings agencies are providing ratings to financial institutions where they have also provided guidance on the risk management techniques that they should employ.

We do not at this stage believe that such activities should be expressly prohibited by the SEC. However, we do remain concerned that the provision of such services creates the perception of bias in ratings subsequently provided. Indeed more than one of the ratings agencies has stated that they will reward firms that have appropriate risk management systems with higher ratings. The situation parallels the potion that previously existed with the accountancy arms means that the ratings agencies are providing ratings to financial institutions where they have also provided guidance on the risk management techniques that they should employ.

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practices where there had been concern at such firms providing consultancy services to those firms to which they provide external audit services. This resulted initially in an effective prohibition of the provision of such services, although these rules have now been relaxed.

The industry has a difficult conundrum to deal with. The market needs ratings agencies that are independent and also needs them look at issues from a series of different perspectives. Anything that creates a potential for bias within such a system is to be abhorred, yet both the ways that the ratings are paid for and the provision of additional services provides the perception that such bias might potentially exist. The alternative is rather draconian and would require a central levy to fund the provision of ratings by quasi-governmental agencies that cannot provide any other services. We have real concerns whether such an agency would either be effective or sufficiently accountable.

We would also welcome the development of a new ratings competitor with a non-US perspective to form some level of balance to the existing market participants.

We would also welcome the development of a new ratings competitor...
Risk Reward Limited experienced significant growth during 2008 which we expect to continue during 2009. Our City of London have some new faces since September 2008 who now occupy the 4th floor at 46 Moorgate: why not contact them with your enquiries for your local risk management needs?

Mr Nick Barcia email: NB@riskrewardlimited.com in New York City for North American enquiries.

Mr Colin Egemonye email: CCE@riskrewardlimited.com can do the same in Ibo for those in Nigeria.

Mr James Mushore email: JAM@riskrewardlimited.com for Southern Africa enquiries.

Mr Yuri Ganfeld email: info@riskrewardlimited.com can provide consultancy and training course descriptions in Russian and throughout the CIS region.

Mr Peter Hughes email: PH@riskrewardlimited.com is help in Brazilian/Portuguese and in German.

Ms Lisette Mermod email: LM@riskrewardlimited.com would be glad to help in French.

Ms Cariska Pieters email: CP@riskrewardlimited.com is also ready to assist in Afrikaans.

During 2009 we are scheduled to deliver both consultancy and training business in both Russia, the CIS and the USA, and in Egypt.

We are also completing the editorial touches on Money Laundering for Beginners published by Wiley Financial and the Securities and Investments Institute and the International Handbook for Money Laundering Deterrence, also published by Wiley Financial.

Why not reserve your copies in advance and benefit from a pre-publication discount by emailing Adnan Hussein at info@riskrewardlimited.com. The author and editorial team at Risk Reward Updates do hope that we are able to share ideas and even meet with more of our subscribers during 2009 and wish you all the best for the New Year.

NEW for 2009: Islamic Finance Suite of Training Courses

Risk Reward has been serving the banking and financial services sectors in developed and emerging markets, providing risk consultancy and risk training, since 2002.

To date we have assisted over 100 banks in developing, reviewing and implementing risk policies, protocols and procedures in the UK, Europe, Africa, the Middle East, and Asia. Specialist risk consultancy is quality and customer service driven with a clear focus on value for money, especially in emerging markets.

Risk Reward’s training division has doubled in scale of activity again in 2008 from 2007. The training centre provides over 500 expert consultants/trainers, training course content and materials for public and in-house courses. We supply most major international training companies offering banking and financial services training in global markets.

New for 2009 Risk Reward are the Islamic Finance suite of courses, including

- Islamic Banking & Finance
- Risk Management in Islamic Finance
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