This entire issue is given over to the Credit Quake. It works from the position that we are where we are and there is little to be gained by looking for scapegoats and culprits. Instead our consultants look at a range of areas where change could be required or may be proposed and consider where action should, or should not be taken. We start by publically answering some of the questions that have been posed to Risk Reward Limited consultants in recent days and then look at the various areas where change may be requested or required, recommending areas for action as appropriate.

1. The Key Questions

How long will the crisis last?

We are regularly being asked for our views about the crisis. Our view remains that there will remain turbulence in the financial markets until the conclusion of the US election and that recovery will commence in December 2008. However the recovery will be sporadic and certainly not euphoric. We expect 2009 will see a gradual return to what will become a relative normality, although the credit markets will remain cautious throughout 2009 and probably into 2010.

Will more banks fail?

This question has appeared in almost every meeting that we have had with senior bank management. As many of you will be aware we had expected some additional banks to fail in the June to September quarter.

It is our view that the main failures have now taken place and that increasingly the remaining global players will now be in a position to capitalise on their success. Whilst a few secondary players will disappear through reorganisation of the sector, this will be due to merger and acquisition activity rather than any form of administration.

It has become clear in recent weeks that most governments are prepared to nationalise or rescue any further struggling banks.
How will investment banking change?

There can be no doubt that investment banking will change as a result of recent events. We believe that the days of the feast are, with regret over. However not all corporate activity on which the investment banking scene was predicated will end. We do not expect there to be a flurry of new issues for either equities or bonds in 2009. Instead a few transactions will take place which slowly rebuild some degree of confidence in the system.

There will be growth in 2009 and 2010 but activity levels will not return to historic levels until probably 2012 t the earliest. Without the pipeline of transactions which are the lifeblood of the investment banking sector, it will shrink dramatically with a few global players together with niche boutiques providing the support. Basically we expect that part of the industry to decline to perhaps only 25% of its size prior to the crisis.

2. The Global Regulator

Whilst there is no global regulator for the entire banking industry, banks of course each have a single Home Regulator that takes ultimate responsibility for the regulation of the institution. These Home Regulators need to work closely with Host Regulators to make sure that the regulatory system works effectively. These rules have been revised fairly recently and should be allowed to work.

Of course that is not the issue that is concerning the market. The suggestion is being made that we now require some form of global regulator to take some level of international oversight. Our view is that any such development is bound to cause more problems than it solves. At present there are two bodies which operate on a global basis and have impacted on the crisis.

The first is the Bank for International Settlements, which is essentially the committee of banking governors. It is not answerable to anyone and is able to make rules that impact on the global markets. If there is a view that regulation needs to be altered globally, then the Bank for International Settlements already provides the mechanism for this to be achieved.
2. The Global Regulator (continued from page 2)

If there is a view that regulation needs to be altered globally, then the Bank for International Settlements already provides the mechanism for this to be achieved.

The other global body is the International Accounting Standards Board. Again not really answerable to anyone it is able to design standards of disclosure, valuation and reporting for the financial services sector which are then imposed on the industry through the rules of individual stock exchanges and by regulatory pressure.

The key problem with any global body is oversight and that has been shown to cause difficulties in the current crisis. A solution that may be theoretically brilliant could be practically useless. Increased scrutiny of these global institutions is required – but who should do it and to whom should they report? Without oversight these bodies can tend towards academic solutions which themselves create additional issues. It is the absence of such a reporting mechanism to ensure accountability that results in our opposing the creation of another unaccountable global body.

Our view it holds that the regulatory status quo remains the least worst solution. However we do believe that major and urgent changes to regulation are required.

3. The Bank for International Settlements (BIS)

The BIS have been putting the global banking industry through Basel 2. This standard has changed many times since its original drafting and is already out of date. There are real problems with the standard which have become increasingly clear during the current crisis.

If you look at the three risks which are addressed directly in Basel 2 you immediately see the concern. Credit risk is primarily based on historic loss data which should be across the credit cycle. The capital required currently covers both expected and unexpected loss at a 99.9% confidence level. Market risk is based on a mark to market calculation using historic data over a 99% 10 day VaR. This clearly is not predictive and again covers both expected and unexpected loss.

Operational risk uses a range of techniques (internal and external loss data, control and risk self assessment, scenario modelling and stress testing) to identify at a 99.9% confidence level expected and unexpected loss. Budgeted losses can then be taken into account and the result is supposed to be a forward looking estimate of un-budgeted and unexpected loss.

Strategic and liquidity risks are not addressed in the Pillar 1 charges, but are instead covered in Pillar 2, hence the lengthy ICAAP reports that many banks are doing. So what is wrong?

Clearly a bank needs to implement Enterprise Risk Management, capturing each risk they face on a consistent basis and enabling a Board to properly understand their risk position under a range of plausible yet extreme scenarios. This is also what the regulators require. There is no point in a regulator understanding how much a bank would lose in credit risk from a specific event if the impacts on the other risk types cannot be gauged. Basel 2 needs to be completely redrawn to ensure that it deals with all risk types on a consistent basis. It should require Enterprise Risk Management to be implemented in every bank worldwide. No rule should be produced by the BIS which is contrary to this objective – accordingly the current SILO committee structure should also go. The focus for all risk types needs to be on unexpected loss regardless of risk type.

There is no point in the regulators wasting their time looking at expected loss, which is a decision for management as part of product pricing and profitability discussions. Far too much regulatory effort globally has been wasted looking at things that, in retrospect, do not seem to matter.

4. Financial Education

As a firm that specialises in financial services training we have been dismayed by the rather limited level of familiarity with global finance that has appeared in debates, political statements and in the press.

Global finance has become of greater complexity and it is incumbent upon the market to provide better training to the population in general. This should clearly start in the schools and we would hope that finance becomes an integral part of general education. However in the short term we clearly need training for journalists and politicians so that they have some understanding of the matters on which they are expounding with such passion. Many public speeches and discussions have exacerbated a difficult position through repetition of half truths and relatively incomplete analysis.

We believe the global market should demand a more qualitative approach from its political leadership and encourage the spread of quality financial education and international best practice, as is being encouraged by the ICAEW, for example.

5. Legislation and Split Regulation

The US continues to have a multiplicity of regulators for different parts of the financial services industry. Put at its simplest this just cannot work. It is important that the US now moves to combine all of its regulators into a single Markets Regulator enabling that regulator to understand the impact of actions in one part of the industry on other parts of the industry.

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5. Legislation and Split Regulation

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In the UK there is less need for change. The legal structure is sound and can address any change that is necessary. What does need to change dramatically is the Bank of England and the Financial Services Authority rule book. This is too long and too detailed to meet the needs of the market. A move back to principles and objectives in regulation would be much more effective. Rules that do not clearly add value to the overall objectives of regulation should be abolished. Perhaps the FSA could adopt an objective of halving the size of its rule book in a year.

A better focussed series of rules and regulations would be far more appropriate that the detailed analysis that is currently in place.

We remain concerned that there will be knee jerk regulation in response to the crisis. Without doubt any regulation passed in haste will need to be repented at leisure. Putting additional burdens on the banks at this stage will slow their recovery and deepen problems in the economy generally. This should be avoided.

There will be countless people calling for additional disclosure and reporting from the banks. Much of this will be based on the bizarre notion that reporting would have made any difference to the crisis. We take the firm view that additional disclosure to the markets is the least of the problems that we are currently facing,

Bank’s accounts are full of disclosure, much of it academic, such that the accounts are already almost impossible to decipher. Additional disclosure will make them even harder to understand and the weakness of the press to analyse such matters would actually cause the next failure to be even worse.

Without doubt the main cause of the current credit crisis was liquidity. However, from a regulatory perspective, what we believe is required is not more disclosure, but better disclosure and here we take issue with international accounting standards. IAS39 in particular is one of the causes of the crisis effectively requiring assets to go to fair value regardless of the reason why they are held. In our view it remains completely incorrect to force a fair value adjustment onto an asset which is likely to repay at full value.

The standard resulted in securitised asset tranches no longer being appropriate for exactly the reason that they were created. Without anyone else actually wanting the assets the results were always going to be obvious – firefall of securitised asset prices. These are not toxic waste mortgages, purely an accounting standard that has undermined an entire market.

Again too many people are aiming their fire at the wrong culprits.

6. The International Accounting Standards Board

The IASB needs to replace IAS39 as a matter of urgency. They also must make sure in future that their theoretical ideas are fully reviewed to understand practical impacts and also the law of unintended consequences which clearly applied in this case.

7. The Banks

Enterprise Risk Management (ERM) must be the new mantra of all banks. Our views are that for too long many banks have not really embedded risk management fully into the way that they do business. The consequence is that unexpected events cause them to have unexpected problems. The embedding of risk management such that all staff really understand their roles within the Bank and how that leads to ERM being achieved has not been done.

This will need major educational programmes and changes to systems and behaviour. Risk management will need to be far more approachable and appreciable to all staff. It is not a regulatory construct, it is the way that you should do business to ensure that your institution survives.


Risk Reward Limited UK

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 by developing, reviewing and implementing risk policies, protocols and procedures in their business units across the UK, Europe, Africa, the Middle East, and Asia.

- High-quality deliverables
- Integrity & Trust
- Customer service excellence
- Good value for money
- Focus on the needs of global emerging markets

Risk Reward’s consulting and training division has surpassed all previous goals in scale of activity again in Q3 2008 as more banks and financial institutions seek our consultants as their preferred qualified, experienced and easy to work with specialists who will come to them at any location. This summer has seen our Internal Audit services grow to provide critical technical support to a major Middle East Islamic Bank and to a Swiss-based asset management house seeking to professionalise and become fully compliant with it’s bank acquisitions, dealing room facilities in London and launching hedge fund products in emerging markets.

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