15 JANUARY 2009

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Risk Reward Limited
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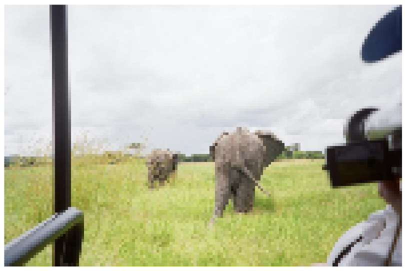
Q4 2008 RISK UPDATE

***Global Credit Quake** Issue 4 Vol 2. On occasion we will focus on a single issue with macro economic impact. The opinions are solely those of the editor.*

Contents

Risk Managing the Elephant in the Room

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

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To the Editor

Do you have risk issues in your organisation or region you would like to share? Email your thoughts to the Editor at DWC@riskrewardlimited.com

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Risk Managing the Elephant in the Room *(Continued from over)*

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

'… bank borrowing is in effect being replaced with government borrowing, is one of the most surprising outcomes of this entire process.'

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.

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 administrators could see them in court?

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