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 same time when people are feeling times are tough.

Basically the government has taken 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.

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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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 source. We believe that this will be credit risk where firms utilising the standardised approach in countries where general provisions are a reduction in UK property of 10%-15% and for UK commercial property prices of around $30 - $40 is to be expected. 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.

The Oil Price

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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