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

The Bank for Int'l Settlements

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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

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unexpected event it will either happen or it will not. One fiftieth 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)

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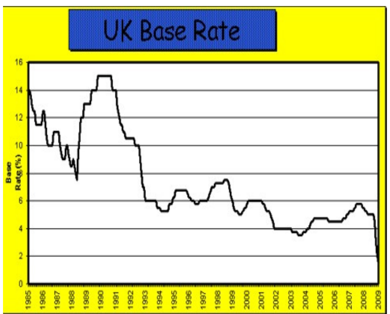

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is higher than actual inflation and then drives wage inflation.

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.

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.

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