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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 UPDATE Q1 2009

THE CREDIT RESPONSES ISSUE

The G20 Response - The Future of Financial Services Regulation

So the G20 has met and looked into the abyss of the financial crisis and come up with… very little.

The key issues that they have raised are the following:

- Tax havens
- Bank secrecy
- Bank regulation
- The Financial Stability Board

There is very little new in any of these pronouncements. The concern that you will be having is whether this will actually work in practice. Our view is that the current discussions, were they to lead to new regulations, would certainly provide no benefit and could actually harm further the global economy.

Tax Havens

Firstly tax havens. G20 governments have concluded that these are bad things. This is nothing whatsoever to do with the financial crisis, rather it is about the G20 trying to use their weight to stop smaller countries earning income through offering low cost and low taxation environments. Of course some of the best low tax environments are actually on shore, not offshore; with perhaps the Dublin free zone being a typical example. This is purely a grab for tax revenue and nothing to do with the current financial crisis.

Bank Secrecy

Now Bank Secrecy. We are seeing pressure on many jurisdictions, including Switzerland and Luxembourg, to provide further information on their customers. The objective is once again to reduce tax leakage from G20 countries and to assist money laundering deterrence efforts. This is a relatively pointless gesture that will result in a lot of discussion, but very little value. Money laundering will not reduce unless crime reduces and there is little evidence of that. We are in the process of issuing a new book on Money Laundering (not money laundering deterrence) to be published by Wiley in the Summer which will consider this issue in more detail.

The Financial Stability Board

The Financial Stability Forum is part of the Bank for International Settlements structure and has previously issued papers which are more aca-

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demic in their outlook. It has been great for research papers and the development of ideas. Is it the right place to look at contagion within the financial sector? We would suggest that is not right.

The Bank for International Settlements is a committee made up of central bank governors of the G10 with a few added members. By passing this responsibility to the Financial Stability Forum and renaming it the Financial Stability Board the G20 is again making sure that they have the key controls over the issue. Basically smaller institutions are excluded.

The solution should have been to create a forum within the International Monetary Fund, probably using the already existing Institute for International Finance. This is a global grouping which includes elements from all areas of interest in the financial community, including governments and banks. Surely that is a better forum for discussion.

'...the focus in the Basel Accord on credit risk and operational risk, with no changes to the massively inappropriate market risk rules, did take the eye of management away from certain risks that really matter.'

Bank Regulation

The current discussions seem to be suggesting a "back to the 1950s" approach to banking. What we would like to say to the G20 is "Well if you all want to go bankrupt, go ahead." Put at its simplest, for every £1 reduction in the borrowing by a bank, you add £2 to the borrowing by a government. This simple adage has been made very clear in the current crisis.

The Role of Capital

There are so many issues with current regulation that need to be addressed, that they have failed to do so is perhaps disappointing. A single concern is the role of capital itself. What is capital actually for? We seem to spend enormous amounts of time discussing that this bank or that bank has a capital ratio which is below the market expectation – but what does it mean?

The logic for capital maintenance has always been that it is to protect the market from a failure of a bank in times of stress. Effectively it is a fund to cover a rainy day. Guess what – it is not just raining, there is a storm outside. Surely if capital has any use at all it should be being used at present? ***That means that in times of stress, capital requirements should be reduced.*** They would then be built up again during the good times to cover the future expectations of disaster. It would suggest a cyclicality to regulatory capital which is not there at present.

The Regulations Themselves

Were the regulations the cause of the crisis? Actually the focus in the Basel Accord on credit risk and operational risk, with no changes to the massively inappropriate market risk rules, did take the eye of management away from certain risks that really matter. We have said in previous Risk Updates going back many years that we were concerned that banks were not prioritising the modelling of liquidity risk. This was in part due to the regulations not requiring such movement, but also due to the availability of liquidity being such that nobody really worried.

What we do need is for a regulatory regime that actually is consistent and logical. ***We do not need more rules, we need better rules.*** All of the risk assessments required by the Bank for International Settlements should be directed at ensuring a bank knows what the risk might be if certain plausible events were to occur in the future. There should never be a capital requirement for anything that a business budgets for. That is just illogical – if a risk is addressed in product pricing then it does not need to be included in a capital charge.

The rules need to be consistent and all to the same confidence level. No longer should the market accept a combination of 99.9%, 99% and 96% as being acceptable. Actually we recommend abolishing all of the risk committees at the BIS and replacing them with a single risk grouping that will deal with all risk issues. This will hopefully result in a consistent and intellectually valid approach to regulation. Of course there is no intellectual rigour regarding the minimum capital rules of 8% and there is no evidence that expected losses can be used to infer unexpected or unlikely losses; so there is actually rather a lot to do.

We are firmly in the camp that believes principles-based regulation is the only approach that is effective.

The G20 Response

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If the regulators end up trying to go for detailed rules, this effectively results in regulators and governments trying to run banks, and with regret that can only end in tears. Just look at what the governments are actually doing at present – can much of it make sense? If the crisis was caused by problems of liquidity and rules requiring assets to be priced to a market value which massively understates inherent value, then these are the issues you need to deal with. There is no evidence that this was understood by the G20.

The Role of Non-Executive Directors

Separately we have seen thoughts that non-executive directors should be in a position to question management appropriately. Clearly risk specialists are the ideal candidates for such roles and we think that this is a useful addition to the debate. As a firm we possess access to one of the largest groups of experienced risk professional in the world and anticipate receiving regular requests for non-executive directors. Our risk specialists all have more than 20 years of relevant experience and can add significant value to the Board discussions at any financial institution.

New High Level Principles for Risk Management

The Committee of European Banking Supervisors

On 8 April 2009 CEBS issued a consultation paper (CP24) on High-level principles for risk management. According to this analysis, "EU and international supervisory bodies have produced a comprehensive set of guidelines covering all aspects of risk management". You may well disagree with this statement, since our view is that such principles are inconsistent and incomplete. The CEBS does state that "the coverage of the guidelines is somewhat fragmented". They also note that CEBS' guidelines have gaps in the following areas:

- Governance and risk culture
- Risk appetite and risk tolerance
- The role of the Chief Risk Officer and risk management functions
- Risk models and the integration of risk management areas
- New product approval policy and process

The CEBS has consolidated all of its principles and guidelines addressing risk management into a comprehensive guidebook.

CEBS state that these high-level principles proposed in CP24 should be considered both by institutions and supervisors within the supervisory review framework under Pillar 2 (i.e. the ICAAP).

Whilst these principles are aimed mostly at large and complex institutions, they can be adapted to any institution under review, taking into account its size, nature and complexity.

The High Level Principles

These fall under the same headings set out above. In this brief article we only set out a few issues of specific interest. For the full information, reference should be made to the original document.

1. Governance and Risk Culture

They require a comprehensive and independent risk management function under direct responsibility of

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