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 onshore, 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-
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.

**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.

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.
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
the senior management. They also require that the management body have a full understanding of the nature of the business and its associated risks. Specifically they are looking for senior management with capital markets experience, although the key from our perspective is for the non-executive directors to be in a position to adequately challenge risk management.

They require that every member of the organisation must be constantly aware of his responsibilities relating to the identification and reporting of risks and that a consistent risk culture must be implemented, supported by appropriate communication.

2. Risk Appetite and Risk Tolerance

CEBS state that risk tolerance should take account of all risks, including off-balance sheet risks. Then the paper requires management focus on consistency of targets, with responsibility residing with the management body and senior management.

In our opinion there is much confusion surrounding risk appetite and risk appetite modelling and it is perhaps disappointing that this paper does not really add any clarity to the issue. Risk appetite in our view is a single metric that is then converted into a series of measures as appropriate, driving behaviour and control systems appropriately. We are seeing many installations that are impossible to either use in practice or fail to add value to their institutions - and the solutions are having to be changed and simplified significantly. A little more clarity of thinking would be of assistance here. The remainder of this section repeats wording from the Bank for International Settlements (BIS) Sound Practices paper from 2003.

3. The Role of the Chief Risk Officer and the Risk Management Function

Basically there needs to be a person responsible for the risk management function across the entire organisation – and this means all risk types. They need to have sufficient independence and seniority to challenge (and potentially veto) the decision-making process and possess the expertise that matches the institution’s risk profile. From our experience many of the CRO roles do not have this level of authority. Further, the professionalisation of the risk management function is at a relatively early stage of development; so many risk professionals are only comfortable in certain risk areas. Perhaps they really understand credit risk, but not operational risk. Perhaps they originally commenced in market and liquidity risk, but counterparty credit risk is beyond them. As an enterprise risk management firm we recognise both the challenge and the opportunities that a developing ERM framework and CRO can provide to any firm.

Importantly CEBS state that risk management should not be confined to the risk management function, since it needs to be in the business. Perhaps this is one of the failings of certain functions we have seen, where the risk professionals have undertaken significant assignments without the business actually being impacted. This has to be the wrong approach since risk management facilitates the implementation of policies and procedures, rather than actually undertaking the primary transactions itself.

4. Risk Models and Integration of Risk Management Areas

CP24 requires firms to identify and manage all risks whilst avoiding over-reliance on any specific risk methodology or model. The requirement for a risk register would therefore appear obvious and we would suggest that this should be clearly linked to the control framework and risk appetite. These concerns over risk models have surfaced before, being prominent in the 2008 Banana Skins survey promulgated by the CSFI (Centre for the Study of Financial Innovation). CEBS raises concerns over the conceptual limitation of metrics and models, highlighting the need for qualitative and quantitative data to be combined, with stress tests being considered. This also provides many firms with a challenge related to the natural inaccuracy of much of the modelling that is conducted. This should not concern banks unduly since much of this data is actually required for strategic risk management as opposed to tactical risk management and accordingly the same level of accuracy is not necessary.
5. New Product Approval Policy and Process

There is nothing much in this section apart from a requirement for a new product approval policy and new product due diligence.

Conclusion

I am sure we will not be alone in thinking that the CEBS could have provided more useful guidance in such an important area. It is perhaps the issues that they have failed to address - in particular the development of an enterprise risk management framework and the role of the non-executive director - that provide us with the greatest disappointment.

There are however a few key messages, perhaps the loudest of which is that risk management is now central to the way that an institution operates and can no longer be relegated to a more junior level. The elevation of risk management as a principle driver must be welcomed and the CEBS therefore generally applauded for their added impetus.

www.riskrewardlimited.com

The Turner Report Reviewed - The FSA’s Response to the Credit Crisis

What is the Turner Report?

Lord Adair Turner, Chairman of the FSA, has recently published his much heralded report on the credit crisis. He examines in sometimes tedious detail the causes of the failures leading to the crisis and then sets out his recommendations for the future.

It is worth noting that the UK’s FSA is the first major regulator to publish such a detailed report although its release just before the G20 Summit in London may be seen as both timely and pre-emptive. Some might argue that it actually was presumptuous. It is clear that Lord Turner and the FSA are hoping that their proposals will be both taken up in the UK and internationally. Many of the changes recommended by Turner go to the heart of the Basel Accord and impact on the international regulatory and supervisory frameworks.

Indeed, given the international and global nature of so many of the key market participants, really effective regulation can only work if it is implemented across each of the key financial jurisdictions on a consistent basis. Only by achieving this can regulatory arbitrage be avoided.

Turner’s View of the Causes of the Crisis

Turner identifies three underlying causes of the crisis:

- Macro-Economic Imbalances
- Financial Innovation is ‘of little social value’ and
- Important Deficiencies in Key Bank Capital and Liquidity Regulations

These, Lord Turner says, were underpinned by an exaggerated faith in rational and self-correcting markets. He makes an obvious observation in stressing the importance of regulation and supervision being based on a system-wide “macro-prudential” approach rather than merely focusing solely on specific firms.
Readers of previous Risk Updates will know that the first two issues were actually nothing to do with the crisis and to blame them in our opinion suggests faulty analysis working from an invalid hindsight perspective. Given that we disagree with the analysis conducted by Lord Turner, it is perhaps unsurprising that we have reservations about his recommendations.

In his report Lord Turner added that "The financial crisis has challenged the intellectual assumptions on which previous regulatory approaches were largely built, and in particular the theory of rational and self-correcting markets. Much financial innovation has proved of little value, and market discipline of individual bank strategies has often proved ineffective".

He identified the “fault lines in the regulatory approach”, due to the globalisation of banking activities, which led to “global finance without global government”. This is an issue that has been recognised for many years and appears within the Basel Sound Practices paper from 2003. Indeed the Basel Accord and subsequent papers were specifically designed to deal with such matters. However, was Northern Rock really caught because it was a global institution? What about Fannie May or Freddie Mac? Almost all of the institutions that had difficulties – these were problems of liquidity not problems of international regulation.

Unsurprisingly Turner calls for more and improved regulation supported by a more intrusive approach by supervisors and the end of ‘light touch’ regulation. Whether a more heavy handed rules based approach would be more effective is not necessarily an automatic consequence - as the SEC has demonstrated so very recently. It is clear to us that the detailed rules approach - which actually has been followed by the FSA and other regulators (specifically those adopting Germanic approaches) – does not work. The focus on detailed pointless rules stifles innovation and prevents banks from appropriately managing their business. Worse than that, the regulators stop focusing on what really matters and instead look towards death by a thousand cuts. It never happens.

The Turner Proposals

Lord Turner proposes major reforms in the regulation of the European banking market, creating a new European regulatory authority together with increased national powers to constrain risky cross-border activity. In our view this will be a challenge to make happen due to the problems of national rules and the certain disagreement as to where it should be housed. The threat could of course lead to some institutions leaving Europe, which would hardly be in anyone’s interest.

Similarly predictable, Turner proposes major increases in regulatory capital to levels ‘significantly above existing Basel rules’. He does not really justify this because it cannot be justified. The problem that the banks faced was a failure of liquidity, not a failure of capital. Northern Rock did not run out of capital – it just could not get the liquidity it needed at any price it could afford. Lord Turner also calls for a fundamental review of the trading book capital regime not just with a view to increasing capital ‘by several times’ but to addressing the shortcomings of the current VaR approach. Our view is the current VaR regime is a problem and does need to be addressed, but whether capital is the answer is open to debate.

This would, of course, affect banks’ profitability and, particularly in the current climate, would have a strong political impact too since it would reduce banks’ ability to provide credit, which in turn will impact economic growth. What is clear is that everything that Turner is recommending will have the effect of ensuring that the recession is longer and deeper than would otherwise be the case.

More controversially, he recommends counter-cyclical capital buffers, to be built up in good economic times so that they can be drawn on in downturns. As mentioned earlier, this is something that we agree with.

What Turner Did Not Recommend

Interestingly, there are several areas where recommendations were expected but were not made in Lord Turner’s recommendations.

1. Turner has rejected the idea of a Glass Steagall separation of banking and securities businesses as being impractical.

2. Contrary to many expectations Turner has not called for a major review of or changes to the Accounting Standards which so many felt were at the heart of the problems leading to the credit crunch.
3. Similarly Turner highlights areas where he believes it is premature to recommend specific action, but where wide-ranging options need to be debated. These include product regulation in retail (e.g. mortgage) and wholesale (e.g. CDS) markets.

4. While Hedge Funds might expect some greater interest from supervisors Turner did not call for wholesale new regulation for them.

Really the accounting rules are not within the remit of the FSA, which could be the only reason for Turner to keep clear. Were hedge funds the cause of the crisis? Was it derivatives? It is our belief that derivatives have been the savior of the global financial services industry this time and, had they not been available, currency would have failed by this stage.

Dumb or Dumber?

However, amongst his other proposals, Lord Turner has recommended a number of specific changes, including the following:

- Regulation of "shadow banking" activities on the basis of economic substance not legal form: increased reporting requirements for unregulated financial institutions such as hedge funds, and regulatory powers to extend capital regulation;
- Regulation of Credit Rating Agencies to limit conflicts of interest and inappropriate application of rating techniques;
- National and international action to ensure that remuneration policies are designed to discourage excessive risk-taking;
- For the UK he also proposes major changes in the FSA's supervisory approach, building on the existing Supervisory Enhancement Programme, with a focus on business strategies and system wide risks, rather than internal processes and structures.

Was shadow banking at the heart of the crisis? Not really – where is the evidence to support such an increase in costs? The ratings agency issue needs to be covered much more carefully and is an issue we shall return to. If Lord Turner’s suggestions are taken into account this will probably result in the demise of the ratings agencies as businesses.

Basically the increased costs will result in an unexciting volume business becoming unprofitable and we would suggest that some or all will close. Now that would really be an achievement for Turner to take to his grave.

The report also calls for improved risk management and governance and the up-skilling of the regulator’s own staff. As one of the causes for the crunch, Turner refers to a ‘misplaced reliance on sophisticated maths’ which made it ‘increasingly difficult for top management and boards to assess and exercise judgment over the risks being taken’. We have much sympathy with this point of view and do consider that misplaced reliance on inaccurate modeling is a problem. However once again Lord Turner must be stopped from throwing the baby out with the bath water. What we need is better modeling and better trained boards, perhaps including non-executive risk specialists. What we do not need is prejudiced ignorance.

Perhaps, with all the change and fresh thinking that is now being debated, it might be sensible for regulators and bankers alike to reflect carefully on the enormous reliance we do place on models and statistics to the exclusion of good old fashioned common sense. The Accord itself sets very clear objectives for any model – how often it should be tested and validated and the importance of understanding assumptions. The rules are already there – they just need to be applied in practice.

What will be interesting is to see how the global regulators agree or disagree to proceed. There was the appearance of broad agreement at the April G20 meeting in London. However when we move from the discussion stage to the ‘development’ and ‘implementation’ stages will the approach really be a united and integrated one or will it be local and, dare we say, protectionist. Let us hope that the Turner report is not the blueprint that he hopes it is. We do not believe it is the answer to the problems of the current world and also are concerned that the next crisis can be seen in the inappropriate responses being suggested to this one!
The extreme volatility combined with the dramatic value declines in the vast majority of asset classes over the past 12 months has stunned even seasoned investors. Further, the (originally) disjointed and separatist pronouncements by Governments and regulatory authorities following the collapse of the financial markets only increased uncertainty and has led to a concerted drive towards both cash and the most secure of investments, notably US Treasury Bills and gold.

The investment community is beginning to emerge (although very battered and bruised) from out of the glare of the headlights to plan the path ahead. But what path and to where are we heading? If nothing else, the market correction has acted as a catalyst and in many cases has stimulated investors to adopt a "clean sheet approach" to formulate a plan for going forward.

A comprehensive investment strategy covers a multitude of areas including for example, asset selection and allocation, timing, investment risk, capital risk, currency risk, liquidity risk and (in many instances) reputational risk. These areas on their own can be complex and contain sub-areas that could be the subject of lengthy articles on their own. However, the aim of this article is to stimulate some lateral thought on a clean sheet basis to indicate how one can refine a search down to select targeted investment areas.

Where to Start?

But first, how can one describe an investment? In our experience the rationale behind the purchase of investment assets can broadly fall into one of two categories— (I) those assets that are purchased on the belief that they can be sold in the future to someone else at a higher price; or (ii) those assets that it is believed will accrete in value over time (through capital appreciation and/or income). Obviously many assets fit into either or both categories—but it is the investor's rationale (or attitude) behind the purchase that is the segregator, not the asset itself.

Some investors pay great attention to the economic cycle and select and rotate their investments depending on their views of the current position within a cycle and its length and strength. For example cyclical stocks such as steel manufacturers and steel stockholders are the classic early cycle out-performers, but are relatively unattractive later on as the cycle develops.

Another early cyclical play is the general retail sector and, as an example, look at the graph below of the Marks & Spencer PLC share price. For many market participants it may come as a surprise that the current share price is actually above the level of July last year - i.e. before the dramatic collapse in investor sentiment following the failure of Lehmans. Further, despite the company recently announcing a fall in sales of over 4%, the shares have risen by more than 50% from their lows in November – a classic example of the markets looking through the worst of the downturn and anticipating the economic recovery after a recession.

Mark & Spencer
as of 6-Apr-2009
However, in this article, rather than engage in the merits or otherwise of sector and specific stock selection, we shall explore briefly some thought processes behind a few long-term investments ideas. We will leave the related questions such as asset allocation and risk mitigation to later articles.

**Fundamental Research**

Fundamental top-down research can identify major discernable trends that can indicate areas where investors can concentrate their efforts to uncover attractive investment opportunities. The following are three discrete examples selected specifically to demonstrate the breadth that free thinking can lead to.

**Nuclear Power & Thorium**

Since the Chernobyl incident in 1986, the paucity of commissioning new power stations has led to a sharp slowdown and virtual stagnation of global nuclear power generation. There were 340 nuclear power stations in operation in 1987, which grew to 438 in 2002 as plants under construction came on line (with Japan, S. Korea, India, China, France accounting for 62 of these) and currently number 436. Of these, 339 are over 20 years old with 127 of these over 30 years old – which is very significant considering the 40 year standard operating license period.

**Number of Operating Reactors by Age**

(Continued from page 8)
Investment Strategy in the Current Environment (Continued from page 9)

There are a number of ways investors may benefit from this explosive growth. These could include investing in the companies that specialise in nuclear power plant construction and operation. Examples of such companies include Westinghouse in the United States and both EGF and Areva in France. Of course it is for the investor or their advisors to undertake the necessary investigation. Another area might be the companies that mine and process the necessary fuel required by such nuclear plants. These would again include Areva in France, but also companies like Cameco and other specialist miners, such as Extract Resources. A final potential market would be investing in organisations involved in plant decommissioning and the treatment and storage of the waste. Here apart from Areva, another company worth considering might be BNFL Plc.

Fuel Development

One of the biggest problems with nuclear power plants is that the waste fuel and its reprocessed by-products (notably plutonium) can supply the material for nuclear weapons. It was by using the waste from a Canadian-built reactor that India in 1974 was able to detonate a nuclear bomb. There is a need therefore for a new type of fuel to be developed for the nuclear industry which does not produce any such by-products.

Thorium Power, a company supported by the US Department of Energy has been working in Moscow since the mid-1990s employing former Soviet scientists and is researching and testing the use of Thorium as a replacement for uranium as well as developing the ability to retro-fit existing power plants to use the new fuel.

Thorium appears to offer the opportunity of a ⅓ increase in yield and a 70% drop in the overall production of waste and more importantly an 85% fall in the amount of plutonium (not a gram of which could be used for nefarious purposes). Of course, it has to work….

With the largest known deposits located in Australia, North America, Turkey and India, an investment in a Thorium mining company could prove spectacularly profitable should the metal deliver on some or all of its promises.

China

The International Monetary Fund forecast in March this year that it expects GDP growth in China to be in excess of 6% during 2009. This continues the strong growth achieved since China began its move towards a market-based economy in 1978. Over this period of time its economy has grown by a factor of over 70 times with most commentators concentrating their reviews on the manufacturing cost advantages during this period and the resultant growth in exports to the developed world. However, with the strength of the Remnimbi over the past few years and the recent collapse in world trade, this area has suffered drastically.

In our view, China still appears to offer extraordinary investment opportunities – but investors should concentrate on those entities that benefit solely from growth in the domestic economy, rather than dependence on international trade. With a growing domestic economy, the usual sectors should perform well (retail, consumer products and personal banking/credit). An area that has strong growth fundamentals is the delivery of fuel for transportation, including both petrol stations and LNG stations. There is also a rapid growth expected in the use of alternative fuels for taxis, local authority and government vehicles - China Natural Gas has exposure to this area. The recently announced huge Government stimulus through capital and infrastructure spend...
Investment Strategy in the Current Environment (Continued from page 10)

Investors could look further away from the norm to identify areas of future growth that appear relatively undiscovered. Demographics are a very useful investor tool and China is no exception in this. The IMF forecast that China will experience the highest percentage growth in the proportion of the population over 65 in the G20 countries between now and 2040, by a factor of over 3.5 times. This fact, combined with the growth in the wealth of the country would seem to indicate a strong rise in the requirements for the provision of healthcare and related services and products. The fact that the ratio of male births to female births is currently a very high 1.2 in China (versus 1.05 for the world as a whole), would also indicate that investment in the provision of healthcare services in China could be refined further still.

UK Residential Property

UK residential property has historically been an outperforming asset class for investors (see the graphs below).

Total returns of UK asset classes 1970-2008

Risk and returns of UK asset classes 1970-2008

*R long run returns for residential property do not exist but are calculated as Nationwide house price growth per annum plus a 4% net

Source: Property Investigations, Nationwide, IPD
The current demand and supply fundamentals of the UK housing market are in significant disequilibrium, with a housing shortage that has been estimated to equate to between 7 and 10 years of supply (Source: Joseph Rowntree Foundation, Barker Report, NHBC). Projections of the number of households for England & Wales, and London and the South East in particular, indicate that demand for all types of residential property is expected to increase rapidly over the next 20 years. There is no sign that the house building industry will be able to keep pace with these expectations even with the Government’s proposed house-building programme in the South East.

With a high single figure net yield, investors can afford to be patient in awaiting future capital appreciation.

Certain commentators expect that the fall in UK house prices will emulate, or even surpass, the decline in US house prices. However, the characteristics of both the demand and supply profiles for the two markets are very different. Various studies have calculated that the price elasticity of supply for the US market is high (above 1) and is generally between 2 and 4 (meaning that a 10% rise in house prices will lead to between a 20% and 40% increase in the supply of houses) and could be as high as 20. In contrast, Kate Barker in her Interim Review, stated that the UK housing market has “a low elasticity of supply in response to price changes” (i.e. a 10% increase in house prices will lead to less than a 10% increase in the supply of houses). Further her report stated that not only do “UK households have a high income elasticity of housing demand, but a low price elasticity of demand”. This means (i) that as household income rises, the demand for housing rises faster; and (ii) that as house prices rise, demand for housing will not decline in proportion, but much more slowly.

Currently, it is possible to acquire portfolios that yield up to 10% on cost located in and around London that address the market segments with the greatest projected excess of demand over supply. Investing in straightforward physical bricks and mortar provides its own comfort and risk mitigation as compared to derivative and leveraged investment products. With a high single figure net yield, investors can afford to be patient in awaiting future capital appreciation.

In conclusion, the recent market turmoil will, if nothing else, force investors to examine more closely the methods and rationale behind their selection of investment assets and / or investment managers. History indicates that if an improvement is sought, then one’s methods and constraints should change – or at least be examined afresh. It would be contrary to reason to expect things to change whilst doing nothing differently.

Have we really been through a Risk Management Revolution?

Well, they’re not our words. In fact they come from the South African Reserve Bank’s guidance on the Internal Capital Adequacy Assessment Process (ICAAP) which was a key document in a consulting assignment we recently completed for a South African client. So we thought it would be helpful if we spent some time pondering on this so-called revolution. Has one really taken place and, if it has, what are the implications for internal auditors?

There is no question that a risk management revolution has indeed happened and life in a bank, as we know it will never be the same again.

The current financial crisis can be linked to accumulating risk exposures which, in a number of well publicized cases, escalated to $ billions without always finding expression in the affected banks’ financial accounting and risk reporting systems.

The Société Générale fraud and sub-prime failures are such examples. What is also evident is that such unidentified and unmeasured accumulations of risk were not attributable to any particular category of risk but a rather potent cocktail of all of them… credit, market, liquidity and operational.

These events served to heighten the awareness of banks and regulators to the need for the ongoing identification, measurement and management risks across the enterprise. The global regulatory response was Basel II complemented by a requirement from most national regulators that banks confirm, in their Internal Capital Adequacy Assessment Process (ICAAP), that all risks have been identified and measured, are subject to appropriate management and are covered by sufficient capital reserves. There is also a direct impact on internal auditors as every regulatory authority around the world that we are aware of requires that the ICAAP be subject to regular internal audit.

But if the evidence suggests that conventional financial and risk management systems are simply not capturing and reporting all of a bank’s exposures to risk, what chance does internal audit stand of identifying unreported and / or improperly measured risks during the course of their audits? The answer is quite a good one provided the audit plan is suitably risk-based and the audit team has the necessary skills and preparation. This may be easier said than done. There are two ways Risk Reward can help:
Co-Sourcing or the New Way to Ensure Audit Excellence (Continued from page 12)

- **TRAINING.** We have first class internal audit courses that have been developed by leading experts covering risk management, capital management and the ICAAP and our trainers are the best in the business. In the post ‘Risk Management Revolution’ era these are the skills that all your auditors must possess.

- **CO-SOURCING,** a solution that is becoming increasingly popular with our clients. Risk Reward will provide seasoned audit professionals who are experts in risk management and specialize in the technical areas where risk exposures are likely to be prevalent, for example, Treasury. Co-sourcing ensures you have the necessary skills available in your audit team without compromising any of your managerial integrity or auditing methods. Our experts will readily adapt to your auditing methods and approaches and all working papers prepared by them are your property and form an integral part of your audit’s working papers. They can contribute to any aspect of the audit at your entire discretion… audit planning, programme writing, field work or report writing. As we are not a firm of external auditors there are no conflicts of interest. Indeed, on the occasions that there has been interaction with regulators they have positively endorsed co-sourcing.

Asset Management Solutions: for those left holding the (Money) Bag

The ‘Credit Crunch’ has brought new challenges to the Asset Management industry resulting in many participants fundamentally reviewing their business models and product offerings. Asset Managers are focusing on the future challenges and their real, as opposed to theoretical, resilience to cope with extreme or unexpected events.

Asset Management is a core Financial Services industry function but with its own unique demands, challenges and specialisms. We recognise that many of the issues and techniques required to manage and control ‘Buy-Side’ Asset Management businesses are different to other financial businesses.

Accordingly, we have designed a range of services to support Asset Managers. These are offered to:-

- Those working within Asset Management businesses, and for
- Those for whom Asset Management may be part of their wider remit or responsibility (including Independent Directors, Business Managers and Controllers, Risk, Audit and Compliance professionals).

We also offer dedicated courses and advise those who employ asset managers such as Pension Fund Trustees and Institutional Investors.

**Training**

Risk Reward offers a wide range of services specially tailored to Asset Managers including the following courses and in-house training:-

- Asset Management for Professionals
- Asset Management for Institutional Customers and Pension Fund Trustees
- Financial Investments and Markets
- Operational Risk Management for Asset Managers
- ICAAP Preparation and Review
- Risk Assessment Reviews
- Auditing Asset Managers
- Asset Management for Independent or Non-Executive Directors

**Consultancy**

Risk Reward provides support, consultancy and co-sourcing services for Asset Managers including the following:-

- Design and development of a 21st Century Risk Department for Asset Managers
- Corporate Governance and Controls for Asset Managers
- Re-organisations and Restructuring
- Mergers and Acquisitions
- Regulatory Inspection Visit Preparation
Lisette Mermod, Commercial Director and Mark Andrews, Banking Business Development Team Leader (pictured at right) and their teams have the pleasure of speaking to current and potential clients with new enquiries every day from around the globe. Hourly emails are exchanged and telephone conference calls arranged to allow banks and regulators, international training companies, their agents or representatives to speak directly with either a Risk Reward subject matter expert, and/or our commercial or logistics teams to answer questions, make points of clarification, prepare project proposals and course outlines, transfer documents and arrange travel as part of each and every Risk Reward consultancy or training assignment anywhere in the world.

To better meet the high growth in demand for Risk Reward consultants and trainers we are upgrading our telephone/data systems, have increased our staff and are relocating to new larger offices at 60 Moorgate, City of London, UK, (indeed, just a few doors down the street into the old Halifax House building) this summer.

Our new offices will also include up-to-date plasma screen with video conference facilities for discrete, in-house training upon request.

We look forward to meeting you when you are in London—and warm welcome awaits you.

NEW Russian, Brazilian & USA Brochures

In response to requests from both banks and regulators in the Russian Federation and former Soviet Republics Risk Reward has prepared our general services brochure in Russian which can be viewed on the website at http://www.riskrewardltd.com/includes/PDFs/9886RussianBrochure14_4.pdf

Rio & Sao Paolo bankers asked for our full services brochure in Brazilian Portuguese—how could we say nao?

To view or download the Versao Bresileira please visit the website at http://www.riskrewardltd.com/includes/PDFs/BrazilianBrochure23_4.pdf

Boston, New York, Chicago, San Francisco, Mexico City & Toronto asked for someone like Nick Barcia, Risk Reward’s new Head of North America, to be available to them specially.

To view or download the NA brochure please visit http://www.riskrewardltd.com/includes/PDFs/NorthAmericaeBrochure.pdf

‘Did you know we speak Afrikaans,
French, German, Ibo, Hindi, Punjabi,
Gujarati, Brazilian Portuguese and Russian—How can we help you?’

Please Contact Us at Your Convenience

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