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- ☐ Head of Risk Management
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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES
PARTNER IN LEARNING

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 REWARD UPDATE Q2 2008

Financial Risk & Accountancy Issue

Can your risk solutions cope with change?

What an amazing year to be a risk professional. With the problems of Northern Rock, Bear Stearns and Societe Generale to name but three, risk management has never been in closer focus than is currently the case. In this issue of the Risk Reward update we take a look at the current risk climate and the regulatory responses. We also look for the causal links that have given rise to the current climate of uncertainty. In so doing we hope that our readership will gain an insight into the world of risk in banking and its impact on the global markets.

There are some clear messages for the risk management industry and many of these relate to stress testing and scenario modelling. The concerns about risk management techniques have been clearly identified within the Banana Skins report which we discuss later in this issue. In brief we believe that all risk managers need to consider the following:

Stress Testing

The objectives of stress testing are to take a unitary variable and extend this to a plausible extreme. The Bank for International Settlements have identified that more stress testing needs to be undertaken by management of institutions. The problem has been that management can only see plausible from the current market perspective. Of course plausible is likely to be much more extreme that that. Our first clear message is that stress testing should be extended to include plausible but unlikely events. There can be no doubt that the liquidity position of the first half of this year (or indeed the previous two years or so) was outside of the stress testing conducted by most management.

There can be no doubt that had the management of Northern Rock actually applied a comprehensive series of stress tests, leading to management action, then the current problem could have been avoided.

Scenario Modelling

It never ceases to amaze a professional risk manager how he same type of events recur. The problems at Societe Generale are a case in point although in no way unique. Providing staff with the ability to conduct fraud or to mislead management inevitably leads to some party taking advantage of this at some stage.

Scenario modelling, as readers of our Risk Reward Update will know from the past, is used where more than one variable is required to be stressed. It takes information from published events that have impacted upon another institution and applies the lessons to your business. The mistake that many firms make is to take the external event too literally, for that is not the point of the exercise.

Can your risk solutions cope with change? *Continued from page 1*

'There can be no doubt that had the management of Northern Rock actually applied a comprehensive series of stress tests, leading to management action, then the current problem could have been avoided.'

What is clear from Societe Generale and Bear Stearns is that neither firm was able to learn the lessons from other public events and that a potentially avoidable problem became a disaster.

Risk Models

Again this appears as a significant risk within both the Banana Skins survey and also speeches and papers appearing on the web site of the Bank for International Settlements (www.bis.org). The problem with risk models in general are as follows:

1. The assumptions that are inherent in the risk models are not clearly articulated to enable management to interpret whether they remain appropriate
2. The risk models portray a specious level of accuracy which neither the underlying assumptions nor the quality of the data are able to support
3. Modelling techniques are inconsistent so the management are unable to gain a clear understanding of the true position of the firm and the actions that they are able to take
4. The models themselves are not regularly stress tested to see how they cope with changing market conditions
5. Risk specialists working in different risk areas tend to favour different approaches. This exacerbates the problem that there is likely to be inconsistent modelling.

Senior Management Training

Many senior management have risen to senior positions during the last economic cycle. Depending on when you consider this to have started it has lasted for some 15 years during which time a benign market for banking has predominantly applied. Management, including risk management, trained and promoted during this period have not had an exposure to the stress environments of the past, accordingly they may be unable to grasp the current issues and the actions to take in the best interests of the firm. Perhaps they are too close to the issue. It could of course be a fault of the training that has been provided which often focuses on materials provided and designed by academic institutions – theoretically brilliant, practically useless. This is compounded by the confusion and focus of the regulators on expected as opposed to unexpected loss. We shall revisit each of these issues in future issues of the Risk Reward Update and would welcome your views on what you consider to be the key issues of the day. Please sent your ideas to dwc@riskrewardlimited.com

Risk Reward News & Press

PRESS RELEASE

New Certificate in Finance, Accountancy & Business (CFAB) Training Launch Asia

The Institute of Chartered Accountants of England and Wales (ICAEW), and Risk Reward Ltd UK have launched their collaboration to offer accredited ICAEW finance, accountancy and business training to companies, banks, financial institutions in Hong Kong, and Singapore. The prestigious, intensive 5-day public raining programme on

Business & Finance premiers in **Hong Kong September 1-5 and Singapore September 8-12, 2008. Topics are**

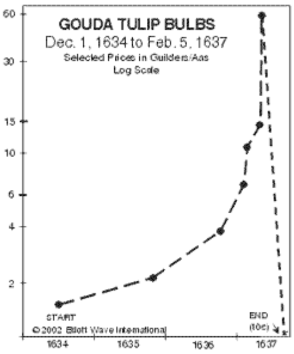
- Introduction to business
- Managing a business
- Organisational structure and business forms
- Introduction to business strategy
- Introduction to risk management
- Introduction to financial information
- The business's finance function
- Measuring performance
- Working capital and treasury management
- The professional accountant
- Structure and regulation of the accountancy profession
- Governance and ethics
- Corporate governance
- The economic environment of business and finance
- External regulation of business

To reserve your place for this new ICAEW accredited course please contact Ms Fiona Lee at +852 2273 4393 or visit www.ethanhathaway.com for more information, prices, in-house solutions and group discounts.

Recently Dennis Cox, the CEO of Risk Reward Limited, presented as part of a panel at the Investment Horizons event organised by the UK based Securities and Investments Institute. At that event he promised to develop some of these themes in the next Risk Reward Limited update.

In terms of our views of the current commodities markets we conclude that there are parallels from the past which do need to be considered. There have been a number of times in the past when markets have left reality with the price of assets either massively exaggerating a trend, or having the opposite effect. It is our view that such matters are entirely predictable.

Tulip Bulbs



The first event of what might be called the modern age was the Dutch bulb bubble. In this case the humble tulip bulb was the subject of major speculation resulting in a pricing spike. The reasons for this are perhaps less important than the result and were the first of a series of "bubbles" ranging from the South Seas bubble to the internet bubble.

Rice

What is most important is to notice the trend – firstly there is a demand led trend and then there is a speculative trend. The end of the speculative trend is a warning that the market is likely to collapse – the only question is how high is the peak and when will the market collapse?

Consider a staple food like rice, for example:

This is a graph downloaded from CME Groups web site. Notice once again the trend. During the period 2002-2007 there is a demand led increase in the market price of rice which lasts until the middle on 2007. At that time speculation takes over and the price exceeds 2,000 in Q1 2008 when the extrapolation of the previous trend would suggest perhaps 1,300.

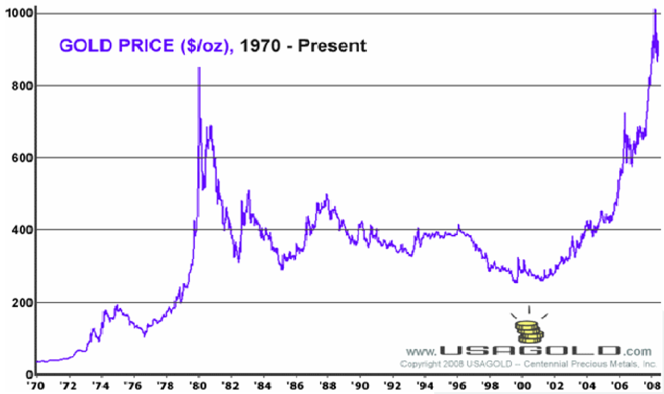
The Risk Reward view is that the long term demand trend for commodities will apply in the longer term and therefore the graph will revert to that position, suggesting a real price for rice (Rough) at nearer 1,400 than the current price.

'It is our view that the market is effectively demand led and that speculation moves the price away from this trend, but that it reverts over the longer term.'

Gold

The key issue is whether this is replicated in the case of other commodities. Let us consider how the gold price has moved:

This graph is downloaded from www.usagold.com and shows some interesting issues. There is once again a demand trend which in this case operates during the period 2001-2005. A speculative trend then takes over, and the gold price spikes. At the peak there is a high level of price volatility which we explain as being the impact of a demand led curve impacting upon a speculative curve. The demand curve would suggest a natural price for gold of perhaps 575 and our view is that the price will long term revert to this trend.



Platinum

Taking this further let us review the movements in the platinum price:

What is Happening in the Commodities Market? (Continued from page 3)

Once again there is a demand pull operating between 2001 and 2007, then the speculation takes over to hit a high point and a period of volatility. This would suggest that the natural price of platinum is in fact perhaps 1,600 and again that the long term trend will revert to such a position.

Copper

Of course not all markets actually have the same level of speculation. In terms of such markets Copper is perhaps a prime example. Because the copper price was previously exploited by unscrupulous traders, this time they do appear to have kept away. Look at the following graph downloaded from www.kitco.com:

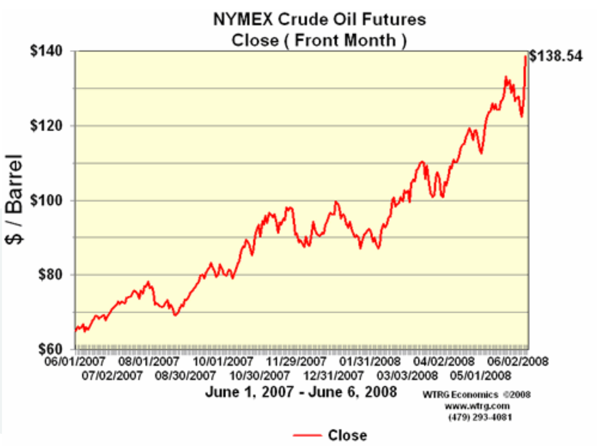
Here there is some evidence of speculation on April-June 2006, but the price has reverted to its long terms demand led trend. Indeed we would expect the copper price to remain above 4,000 for the foreseeable future.

Oil

So the judgement is clear – it is our view that the market is effectively demand led and that speculation moves the price away from this trend, but that it reverts over the longer term. Let us now apply this though process to the oil price:

The graph that you normally see produced is as follows:

This graph care of WTRG Economics shows a relatively steady growth curve, however let us look at the longer term trend:

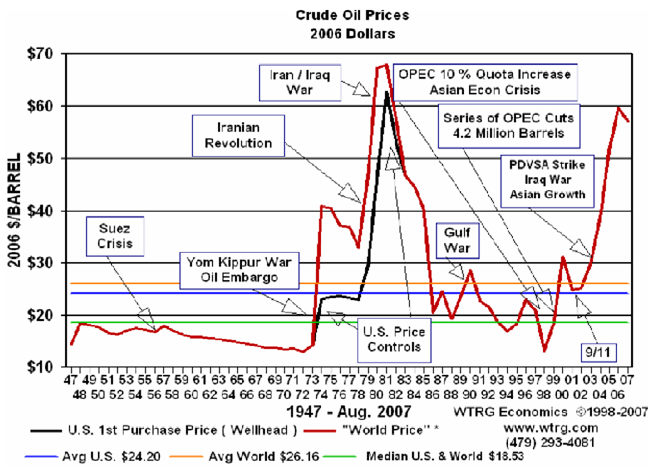


Now we see rather a different trend. Here you see a rather volatile demand curve during 1994-2004 to be followed by a speculative curve. This has continued from 2004 to the current date. What we are now seeing is the volatility that tends to be a signal for the peak of the trend.

Of course in the case of the oil price it is hard to remove the impact of speculation, but our view is that the natural price of oil is in the $50-$75 band. This is consistent with the view of Saudi Arabia which is stating that $60 is the natural price.

The question is not will the price revert to a long term trend; it is when will this happen.

One of the clear messages that come from this is to the teams that are setting interest rates in country around the world. This temporary speculation causes externally generated inflation which will revert. It is important for governments and central banks to discount such inflation in their management of their economies. The classic answer of increasing inflation to reduce demand in the economy and suppress inflation will have the opposite effect this time since the inflation pressures are externally generated, rather than internally driven. The best thing that the economists can do is nothing.



The Problems of Accounting Standards

In previous updates we have discussed IAS 39 and its problems. Of course the problem that we identified then has now occurred. To explain what is happening you do need to go back into the vagaries of IAS 39 (and its ill considered cousin SFAS 157).

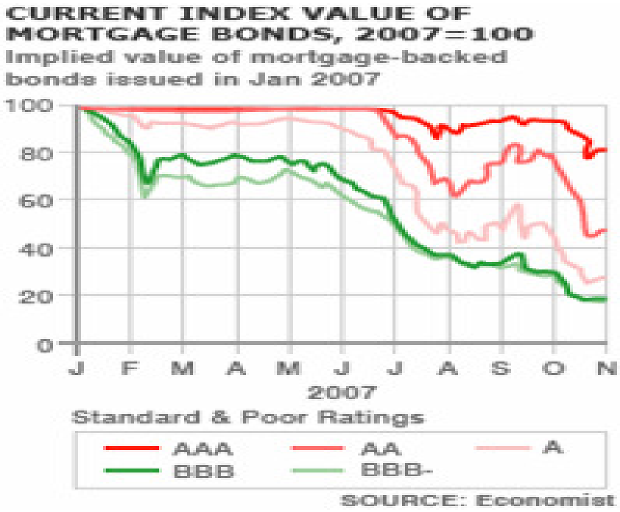
IAS 39 states that assets may be held to maturity in the banking book. If there is a permanent diminution in value then the assets should be written down, the comparison being against what is referred to as fair value. If anything other than an insignificant amount of the assets are sold then all held to maturity assets must be shown as fair value and gains and losses should be taken through the profit and loss account.

Worse than that any firm that sells anything other than an insignificant amount of held to maturity assets loses the right to have held to maturity assets for a period of three years.

The Problems of Accounting Standards *(Continued from page 4)*

Let us look at the current crisis and what is actually happening.

Look at the following graph:



This is from the economist. What you can see is that AAA rated bonds have been written down by 20% under these current rules and the misinterpretation of fair value that is currently occurring. The statistics show that for a AAA rated tranche of a mortgage book to be impacted by a downturn in the market, 29% of the portfolio needs to go into arrears. The figures for Northern Rock were published today – arrears are 0.75%. Not 1%, not 5%, not 25%... but Northern Rock bonds will have been written down by 20% without any prospect that there will be a default.

What this actually means is that anyone that has sold such bonds in the current climate has managed to crystallise a loss that does not exist. The provisions that have been made by many of the financial institutions also do not really exist. If they were to hold the assets to maturity then they would receive full value for such assets. Of course if they have sold such assets, probably under pressure from the media and people that should know better, then they have managed to incur an unnecessary loss.

What should be done? In our view if an asset does not have any long term impairment and is to be held to maturity then it should not be written down – the current speculative market price is irrelevant. In this case we have negative speculation caused by the asset no longer being suitable for the market for which is was designed.

All that this requires is a formal definition of fair value and a change to the terms of Held to Maturity Assets. What is clear is that accounting standards that are developed without considering their implications to business will likely be fatally flawed. ***Come on IASB wake up and smell the roses***.

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The Need for Accounting Training

What this shows is that the accounting rules are becoming increasingly complex and that many financial institutions in particular have a challenge in ensuring that their accounting and finance functions are both up to an adequate standard and up to date.

ICAEW THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES
PARTNER IN LEARNING

The Institute of Chartered Accountants in England and Wales (ICAEW) have recognised this problem and developed a new series of products to meet the demands of this market. Created using existing materials developed to ensure that all chartered accountants meet required technical standards, for the first time non-chartered accountants can study ICAEW materials (either examinable or non-examinable).

The objectives of this new programme are clear. It enables the Finance Director and CEO to know that they finance functions are at least able to meet the benchmark standard that the ICAEW sets for technical competence in the following areas:

- Financial accounting
- Management information
- Business and Finance

'The Institute of Chartered Accountants in England and Wales (ICAEW) have recognised this problem and developed a new series of products to meet the demands of this market..'

Three other modules are also available addressing Audit and Assurance, Taxation and Law and non-examinable advanced courses are also available again using ICAEW produced materials.

These courses are available through the ICAEW training partners and we are pleased to announce that Risk Reward is the leading global training partner for this extended programme.

If you require any further information to see how this could benefit your firm please call Lisette Mermod on 00 44 20 7638 5559 or email her at **LM@riskrewardlimited.com**

Internal Audit Services: Does your organisation need support?

Risk Reward has been undertaking internal audit training, both in-house and public courses, for some years focussing on the following areas:

- Risk based internal audit
- The audit of credit risk
- The audit of consumer finance
- The audit of operational risk
- The audit of treasury
- The audit of Basel II compliance
- The audit of derivatives
- The audit of risk management

As a result Risk Reward has identified the need within audit functions for additional expert resources to be available.

To meet these demands we have developed a new bespoke service which enables one of our experienced internal audit consultants to be embedded within an internal audit function to undertake specific assignments. The objective is for the consultant to transfer their knowledge of the specialist audit area to the audit team, whilst also providing an external view of the issues extant in the specific area.

Our internal audit consultants are available on a daily basis to supplement existing audit resources.

We are currently delivering audit solutions to banks in the UK, Athens, Copenhagen, Stockholm, Hong Kong, Singapore, Riyadh, Dubai and Johannesburg.

For more information and prompt reply and competitive quote for internal audit support services please contact our Commercial Director, Lisette Mermod on 00 44 207 638 5559 or email LM@riskrewardlimited.com

Risk Reward Limited UK

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES
PARTNER IN LEARNING

ACCREDITED TRAINING PROVIDER

Risk Reward has been serving the banking and financial services sectors in developed and emerging markets, providing risk consultancy and risk training, since 2002. To date we have assisted over 100 banks by developing , reviewing and implementing risk policies, protocols and procedures in the UK, Europe, Africa, the Middle East, and Asia.

- **High-quality deliverables**
- **Integrity & Trust**
- **Customer service excellence**
- **Good value for money**
- **Focus on the needs of emerging markets**

Risk Reward's consulting and training division has doubled in scale of activity again in June 2008 from June 2007. The various faculties provide over 600 experts/ trainers, training course content and materials for public and in-house courses and consultancy. We supply most major international consultants and training companies offering banking and financial services training in global markets.

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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