Risk Reward
riskupdate
The quarterly independent risk review for banks and financial institutions worldwide
Q3 – 2009

The Basel Committee

A REVIEW OF THEIR ANALYSIS OF THE TRADING BOOK QUANTITATIVE IMPACT STUDY

BANK FOR INTERNATIONAL SETTLEMENTS

Also in this issue

- UK & INTERNATIONAL SANCTIONS – AN URGENT COMPLIANCE ISSUE FOR ALL
- PROJECT APPRAISAL: ENSURING FUNDERS OBTAIN ADDED VALUE
- ISLAMIC FINANCE
- THE FSA & LIQUIDITY RISK
- WHEN THEY CALL YOU – WHO ARE YOU GONNA CALL?

Dear Subscriber

As we approach the end of 2009 we are continuing to see the impact of fast changing risk and imperfect risk management on the global financial community. The regulators are all developing new regulations and approaches to deal with the issues that they perceive as being at the heart of the problem.

Since much of the perception is not actually at the heart of the issue, some of the actions taken appear to be sub-optimal. In this update we look at two of the recent pronouncements – on market risk from the Bank for International Settlements (BIS) and on Liquidity from the Financial Services Authority. In both cases we do appear to have new rules being implemented which could easily have been significantly improved. In the case of the BIS the inconsistency of their modelling approaches undermines anything that they are trying to achieve.

At Risk Reward we are seeking to provide the market with the information and assistance that they need to deal with the current market conditions. We welcome David Blackmore as Head of our financial crime deterrence team and have included an interview with him in the update.

One of the major issues has erupted in Dubai, impacting Middle East markets and Islamic finance. In this issue we have included articles on both project appraisal and Islamic finance which deal with some of the current problems. Dr Geoffrey Seeff has contributed an article on project appraisal which, in light of the current financial crisis in Dubai, illustrates the importance of carrying out full economic and technical due diligence of any project regardless of the apparent security offered by its financing method. Many of the techniques described in the paper can be applied to the appraisal of distressed projects and of course this may be of particular interest to funders and funders' clients who may be affected in the existing economic climate.

Generally credit risk is perceived to be a major problem for the market and Mary Phibbs has contributed an article dealing with how the market needs to change and deal with the real issues that it is facing. What is needed is clearly forward looking credit risk that effectively deals with the issues of the future rather than concentrating on the past.

We hope you enjoy this edition and look forward to your feedback.

With best wishes

Dennis Cox BSc, FSI, FCA
Chief Executive Officer

INDEX

PAGE

PLEASE CIRCULATE TO:

- ☐ Chief Financial Officer
- ☐ Head of Risk Management
- ☐ Head of Internal Audit
- ☐ Head of Operations
- ☐ Head of ALM
- ☐ Head of Treasury

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

RISK Reward Updates, a regular newsletter covering insights and global risk issues of interest to the banking, insurance and financial sectors in developed and emerging markets.

Available by subscription via the website www.riskrewardlimited.com. To unsubscribe at any time simply email the editor at LM@riskrewardlimited.com and enter UNSUBSCRIBE in the subject field.

RISK REWARD
MANAGE THE RISKS, REAP THE REWARDS

Risk Reward Limited, serving the banking and financial services sectors with risk consultancy and risk training in developed and emerging markets since 2002. Risk Reward is registered with UK Companies House no 4346234.

THE BASEL COMMITTEE AND MARKET RISK

IN OCTOBER 2009 THE BASEL COMMITTEE ON BANKING SUPERVISION ISSUED THEIR ANALYSIS OF THE TRADING BOOK QUANTITATIVE IMPACT STUDY. THIS HAS LED TO MAJOR HEADLINES IN NEWSPAPERS PICKING UP THE SUMMARY FINDING THAT "THE RESULTS OF THE IMPACT STUDY INDICATE AN AVERAGE (MEDIAN) INCREASE OF AT LEAST 11.5% (3.2%) OF OVERALL CAPITAL REQUIREMENTS AND OF 223.7% (102.0%) OR MARKET RISK CAPITAL REQUIREMENTS".

The capital charge under the revised capital market framework under the standardised measurement method covers:

- General and specific interest rate risk
- General and specific equity position risk
- Foreign exchange risk
- Commodities risk

The capital charge according to the internal models approach is the sum of:

- The higher of its previous day's VaR number and an average of the daily VaR measures on each of the preceding sixty business days, multiplied by a multiplication factor; plus
- The higher of its latest available stressed-VaR number and an average of the stressed VaR numbers over the preceding sixty business days, multiplied by a multiplication factor; plus
- The incremental or comprehensive risk capital charge

Incremental Risk Capital Charge

This is calculated based on a risk measure that includes default risk as well as migration risk for unsecuritised credit products held in the trading book at a 99.9% confidence level, a one-year capital horizon, and a minimum liquidity horizon of three months.

Comprehensive risk capital charge

This is calculated based on a risk measure that can be applied to banks' so-called correlation trading portfolios and captures not only incremental default and migration risks, but all price risks at a 99.9% confidence level and a one-year capital horizon.

The Impact Study

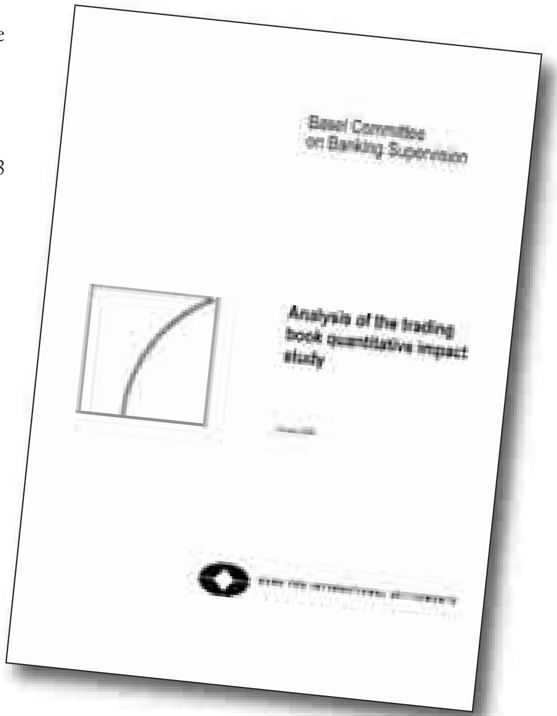
The impact study includes data from 43 banks across 10 countries. Before you look at the summary of key findings it is of course important to consider the methodology that is actually adopted here, which appears in the Annex and Table 7.

Table 7 sets out the "new treatment of specific risk". Taking unsecuritised products, the most advanced approach suggested, the internal models approach suggests the following calculations:

"99% 10 day VaR specific risk measure times three plus 99% 10 day stressed VaR specific risk measure times three plus IRC charge including default and migration risks at 99.9% confidence level and a one year time horizon." Helpfully a foot note allows the three times multipliers to be increased to four times based on backtesting results.

What does this all mean?

It seems to us that Basel has managed to get itself really confused over these criteria. Even the casual reader will see that they are combining different confidence levels (99% and 99.9%) into the same measure and varying time periods (10 days, 60 days, 90 days and a year). Clearly any model that needs to be multiple by three (or four) must give you real cause for concern – mathematically it is a warning to tell you that your modelling has not worked. The use of the multiplier should have caused people to reject a



model that will not come up with the right sort of answer.

If we start with the 99% 10 day VaR, this appears again in the definition of stressed VaR where again the same measure is used working off a one tailed confidence level calibrated to historical data from a continuous 12-month period of significant financial stress relevant to the bank's portfolio. The period 2007/2008 is suggested by the paper as adequately reflecting this.

It is hard to be flattering about such naivety. Stress testing in credit risk and operational risk is set at 99.9% confidence levels. In market risk it is at 99.9% for migration and default, but not for mainstream market risk. This

THE BASEL COMMITTEE AND MARKET RISK CONTINUED

can make no sense. Indeed if the main market risk capital calculation was based on 99.9% confidence levels throughout a higher level of capital would be required – but whether this is more or less than that on average calculated by the inclusion of a three or four multiplier is hard to judge.

Then we have to think about the problems of the periods that are being considered. Basel has always been keen on this idea of a 10 day VaR, looking at 10 day periods as if they are indicative of the risk within positions. There is again a real question here in terms of the 10 days. What is it supposed to really mean? Given that the pillar 1 charge is related to trading book issues including market risk, primarily it is the risk inherent in trading books that are to be assessed. If you are managing a trading book then at the beginning of the day you start with narrow positions, then broaden them out intra-day, before closing them at the end of day to be within end of day limits. The end of day risk is therefore generally considerably lower than the intra-day risk, simply because the trader is not trading the position after the close of play.

Accordingly the end of day positions are not an appropriate representation of the risk in a trading book, nor are they really suitable for the assessment of intra-day risk. Worse than that is the idea of looking at a 10-day period is really rather odd. Ten days is a very long time to hold a position in a trading book, but is not long enough to represent the risk in a banking book. The reservations that we have regarding the conclusions of the paper relate to the flaws in the underlying methodology itself. Put at its most basic, taking stick positions in a trading book at an inappropriate confidence level and multiplying it by three does not fill me with confidence.

That the paper then compounds the error by stating that stress is at 99% on a 10 day VaR, which is inconsistent with the stress testing papers from the BIS. A stress test cannot be exceeded one time in a hundred. That is not the extreme stress event that everyone is so concerned with, or that is being used for calibration as set out in the paper.

The Validity of the Modelling

We do have significant reservations regarding the validity of the modelling conducted to underpin the paper. Responses were received from around 25 banks in 9 countries. Given the number of banks in the world and the number of countries, the mathematical validity of the sample is really only about one standard deviation, or around 68%. That means that even if the respondents had been asked appropriate questions, the response could be materially incorrect.

So what is the next stage? It is clear to us that there remains a level of confusion in both modelling and risk assessment that lies at the heart of this paper. It is clear that the paper comes out with conclusions, but whether these appropriately reflect the real capital requirements is, I am afraid, not convincingly answered. What is required is a more detailed debate about how the risk in trading books and the partner problem of risks within banking books should be assessed. This needs to be conducted consistently with credit and operational risk, avoiding bland multipliers which only highlight the inadequacies of the modelling.

BANK FOR INTERNATIONAL SETTLEMENTS

UK & INTERNATIONAL SANCTIONS – AN URGENT COMPLIANCE ISSUE FOR ALL

This article, contributed by David Blackmore, Director of Financial Crime, Risk Reward Ltd, is focused solely on the UK sanctions regime as part of a two-part series. The next edition of the Global Risk Update Part II will focus on EU and US sanctions and the growing ability of the US in particular to enforce its will outside its own borders

Sanctions – Nothing new then!

Those old enough to remember the early 1960's will recall the Wilson Government's sanctions against the Rhodesian UDI. Since then, sanctions have become the diplomatic norm in lieu of military action and/or blockade, which of course was the tactic of choice by British Governments in the 19th Century. Furthermore, the growth of international bodies such as the UN has reinforced the use of sanctions to achieve some or all of the following:

- To encourage a change in behavior in a target country or regime
- To apply pressure to comply with defined objectives
- As an enforcement tool when international peace and security are threatened and diplomacy has failed
- To prevent and suppress the financing of terrorism, terrorist acts and the proliferation of weapons of mass destruction (WMD)

Despite nearly 50 years' experience of applying sanctions with varying degrees of success, what is new is the extent to which financial institutions and other entities are now firmly in the front line as enforcement agents of both governments and international bodies.

The emergence of financial sanctions

In the UK, the Financial Services Authority (FSA) was established with a Statutory Objective of reducing financial crime. In its Handbook of rules "financial crime" is very widely defined as "… any kind of criminal conduct relating to money or to financial services or markets … including any offence … an act or omission which would be an offence if it had taken place in the UK". Nobody seriously doubts that breaches of sanctions legislation fall within this definition in so far as a regulated firm's systems and controls are failing to implement the legal framework.

Thus the growth of financial sanctions has become an underlying theme on the financial crime agenda in the last few years, and has become much more publicised recently by the FSA.

"The use of financial sanctions to deliver public policy objectives has risen rapidly up the political agenda in the UK, in the European Union and the United Nations. It is important that firms understand that having systems and controls relating to financial sanctions is an integral part of complying with the FSA's requirements on financial crime." – *Phillip Robinson, Former Director of Financial Crime and Intelligence Division, FSA*.

The UK Legal Framework

Four separate authorities have responsibilities for various aspects of the UK regime:

- UK policy on scope and conduct of international sanctions is decided by the Foreign and Commonwealth Office (FCO)
- HM Treasury is responsible for international financial sanctions and the prevention of WMD proliferation
- The Department for Business, Innovation and Skills (BIS) is responsible for trade sanctions
- HMRC is responsible for export controls on sensitive and dual-use goods, including arms.

A variety of legislative instruments have been devised over the years to construct this regime.

- Terrorism Acts, 2000 & 2006
- Anti-Terrorism, Crime & Security Act, 2001
- Proceeds of Crime Act, 2002
- Terrorism (U.N. Measures) Order 2009 / S.I. 1747 which replaced the 2006 Terrorism Order, S.I. 2657
- Al-Qaida & Taliban (U.N. Measures) Order 2006 / S.I. 2952
- Terrorism Act 2000 & Proceeds of Crime Act 2002 (Amendment) Regulations, 2007
- The Counter-Terrorism Act, 2008
- Regulatory Enforcement & Sanctions Act 2008

The key instruments are the two Statutory Instruments passed in 2006 and 2009. The Terrorism (U.N. Measures) Order 2009 / S.I. 1747 and the Al-Qaida & Taliban (U.N. Measures) Order 2006 / S.I. 2952 make it an offence to make funds, economic resources or financial services available to anyone, including individuals and corporate entities directly or indirectly involved in terrorism and/or terrorist financing/activities; to deal with funds or economic resources; to participate knowingly in activities aimed at circumventing the above (new); for an institution to fail to disclose to HMT their dealings.
UK sanctions apply to all UK citizens wherever they work in the world and to all UK incorporated and resident entities,

US INTERNATIONAL SANCTIONS – AN URGENT COMPLIANCE ISSUE FOR ALL CONTINUED

subsidiaries and branches. Sanctions do not apply to non-UK incorporated subsidiaries. The legal consequences of failing to comply with the Orders can be substantial and include fines and/ or imprisonment. HM Treasury has established the Asset Freezing Unit (AFU) to implement the sanctions regime. The AFU maintains a Consolidated List of targets established by the UN, the EU and the UK itself. The unit has seen a substantial increase in activity and funds frozen over the last three years. Some 400 accounts and over £4million are currently frozen. This is despite a number of legal challenges to the Orders, both at the UK and EU levels. At the time of writing the outcome of the leading cases is unknown and so for the foreseeable future it will be "business as usual".

The FSA Report

Following a thematic review in 2008, the FSA published its Report in April 2009 ("Financial services firms' approach to UK financial sanctions"). Its verdict was scathing.

"There are inadequacies in firms' systems and controls to reduce the risk of a breach of UK financial sanctions in all sizes of firms across all financial sectors." *(Para 1.2 "Findings", FSA Report, April, 2009)*.

Serious deficiencies were found in the assessment of the risk, the lack of senior management involvement and drive to implement the process, the absence of approved policies and procedures and the lack of effective staff training. Misconceptions and misunderstandings were in rich profusion, including:

- Financial limit--- there is none!
- No UK-based targets on list--- yes there are!
- Not relevant if don't hold client money--- completely false!
- Tipping – off? --- not an issue since those on the sanctions list already know they are on the list!
- Not relevant if financial crime risk of the firm is low--- not an issue!
- PEPs are same as sanctions targets--- not so, but some PEPs may also be on the sanctions list!
- Not applicable to insurance--- completely wrong!
- AML due diligence = sanctions list screening--- not so, but is clearly linked to it!
- Sanctions are a risk-based approach--- no it is not! Sanctions compliance is a completely discrete legal regime.
- We can rely on others to have done sanctions checks when passing business to us--- not so, unless the accepting firm has verified that the referring firm has completed recent sanctions screening!

In addition the FSA took issue with some firms' use of IT screening products which if not properly installed with adequate data quality and appropriate systems rules will not achieve the desired outcome. Many firms were also ignorant of the procedures to follow if they did have a match or what appeared to be a match to a name on the UK sanctions list. Both the FSA and HM Treasury have promised further reviews and these are highly likely to lead to significantly upgraded enforcement action if firms do not raise their game quickly.

As if this were not enough, HM Treasury recently activated the Counter-Terrorism Act 2008 (CTA) by issuing a Direction on 12th October 2009 prohibiting dealings with 2 Iranian entities suspected of assisting with that country's alleged WMD programme. The CTA contains significant powers of direction for credit and financial institutions thus adding to an already large compliance burden. Coupled with these new obligations are the export control measures and the prohibited investment lists maintained by HM Treasury, HMRC and BIS which together place significant customer due diligence (CDD) requirements on firms, again with a clear linkage to the requirements of the Money Laundering Regulations 2007 and the Proceeds of Crime Act 2002.

Action firms can take

- ✓ Get a clear, firm-unique strategy
- ✓ Senior management to reinforce a compliance culture within the firm as sanctions compliance is not a risk-based regime!
- ✓ Conduct a Gap Analysis to the FSA Sanctions Report, and the CTA Interpretive Notes of HMT
- ✓ Implement JMLSG Guidance, Part 3 – coming soon!
- ✓ Address risks beyond the strictly legal obligations:-
  - o Reputational
  - o Civil liability
  - o US extra-territoriality
- ✓ Review/ upgrade and document your Risk Assessment and Action Plan
- ✓ Ensure the Risk Assessment is approved at senior management level
- ✓ Make sure you can implement your plan, preferably from within but if resource is scarce or the required skill sets are missing then
- ✓ Use experts who understand the risks, especially on I.T. solutions and provide cost effective and helpful solutions
- ✓ Incorporate the results of the above into your staff training and awareness programme
- ✓ Include the upgraded sanctions compliance regime in your Audit Plan/Horizon (internal / external).

The next article is this series will focus on the European Union and USA sanctions and the growing ability of the US in particular to enforce its will outside its own borders.

PROJECT APPRAISAL: ENSURING FUNDERS OBTAIN VALUE ADDED

ALL FINANCIAL INSTITUTIONS ("FI") COMMISSION DUE DILIGENCE APPRAISALS ON PROJECTS WHICH THEY HAVE APPROVED IN PRINCIPLE FOR FUNDING AND WHICH MEET THEIR GENERAL CRITERIA. DESPITE THIS, MANY APPARENTLY SOUND PROJECTS, HAVING UNDERGONE EXTENSIVE APPRAISALS, NEVER REACH COMPLETION OR FAIL TO ACHIEVE THE FINANCIAL OR OTHER OUTCOMES EXPECTED OF THEM.

In this article Risk Reward's Dr Geoffrey Seeff, a Chartered Accountant with over 30 years of appraisal and monitoring experience primarily in emerging markets, uses the example of one of the many projects he has worked on to illustrate some of the reasons why appraisals, unless properly constituted, may not provide funders with the critical information they require to protect their loans or investments and to ensure that forecast returns are sustainable.

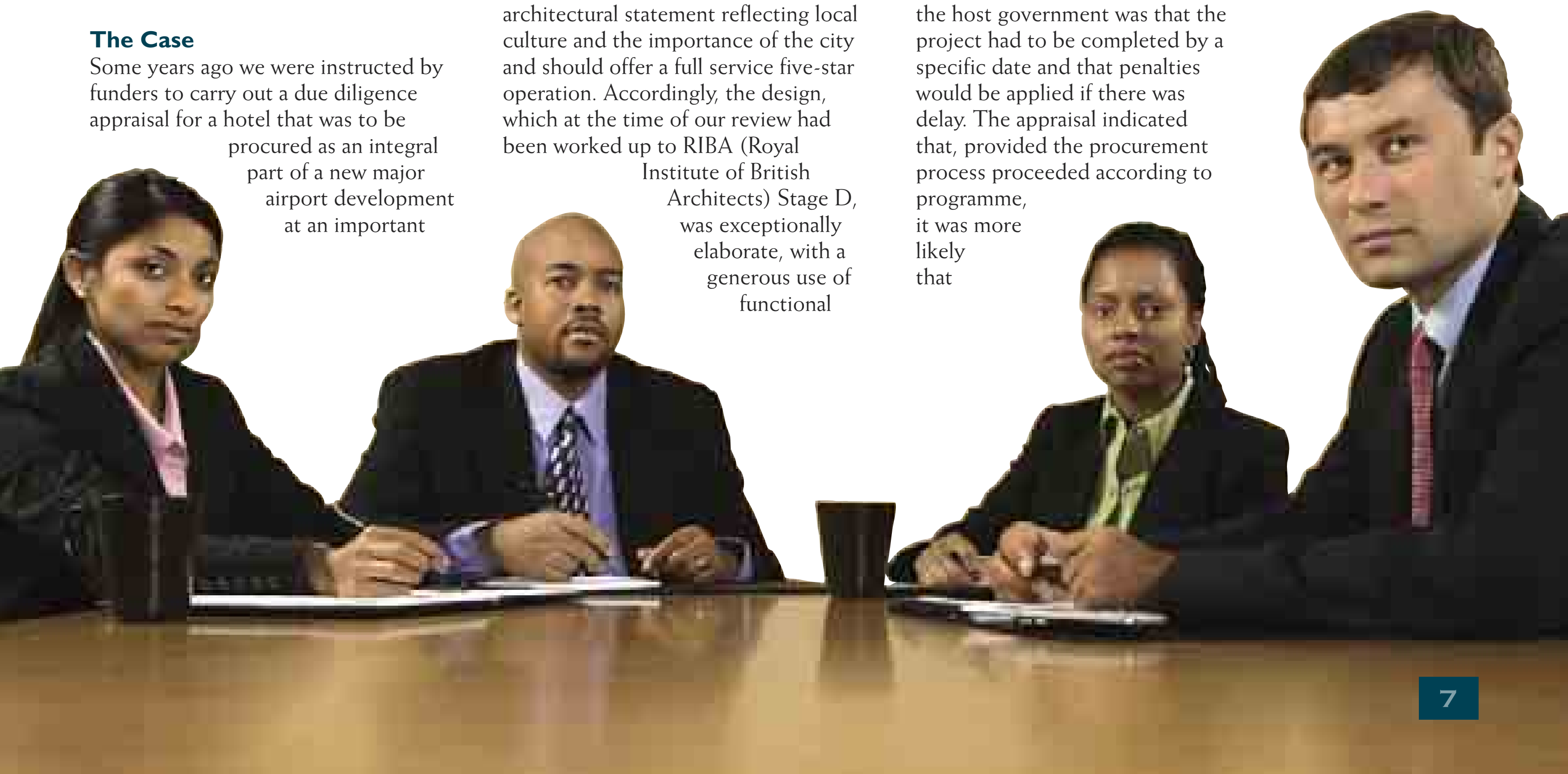
Appraisals are usually paid for, one way or another, by the promoters of a project, so they do influence both the commissioning and conduct of the review work. However, the FI is the final arbiter on their terms of reference and the article provides some pointers as to what prospective funders can do in that regard that will help to ensure an appraisal alerts them to potential problems and practical options for their resolution.

The Case

Some years ago we were instructed by funders to carry out a due diligence appraisal for a hotel that was to be procured as an integral part of a new major airport development at an important European city. There had been an appraisal at the concept stage but since then full technical, market and financial feasibility studies had been carried out by separate international consultancies and they showed that the project's commercial viability was marginal. Thus the project would not have been particularly attractive to third party developers and investors. Meanwhile, under the arrangements entered into with the host country government, the airport developer was committed to build out the hotel and the funders were understandably nervous about their cover for this element of the scheme.

Our review disclosed a number of issues affecting the design and proposed operation of the hotel which were, in themselves unusual and impacted significantly on viability. Amongst other things, the host government had stipulated that, although attached to the terminal building, the hotel should represent an architectural statement reflecting local culture and the importance of the city and should offer a full service five-star operation. Accordingly, the design, which at the time of our review had been worked up to RIBA (Royal Institute of British Architects) Stage D, was exceptionally elaborate, with a generous use of functional space and an excess of ornamental features, and called for a high quality materials specification and. Prima facie these requirements seemed justified by the current market place, as there were few luxury hotels in the catchment area and achieved room rates and length of stays in the city were amongst the highest in Europe. However, closer examination revealed that this was a temporary phenomenon caused by a large number of hotels being closed whilst undergoing refurbishment. Both rates and length of stay, especially at an airport hotel, could be expected to fall dramatically when the market returned to a stable state. Accordingly, we questioned the assumption that the hotel had to be a five-star operation, rejected the designs and recommended that the architects be briefed to come up with a more modest basic structure, albeit with a well appointed interior, the lower costs of which could be expected to generate a healthier IRR.

Another of the many stipulations by the host government was that the project had to be completed by a specific date and that penalties would be applied if there was delay. The appraisal indicated that, provided the procurement process proceeded according to programme, it was more likely that



PROJECT APPRAISAL: ENSURING FUNDERS OBTAIN VALUE ADDED CONTINUED

there would be delays to the opening of the airport or its various transport links to the city beyond the target date for the completion of the hotel. The possibility of the hotel standing empty for an indeterminate period would have represented a significant risk since the government was refusing to offer any form of compensation if this eventuality did in fact materialise. This problem was addressed by making provision for the hotel developer to co-ordinate its construction programme with that of the airport developer so as to ensure completions were synchronised rather than fixed.

In fact, as implied, the project did proceed and has been very successful in meeting the accommodation needs of travellers and securing reasonable returns and security for all stakeholders. However, the outcome could have been completely different, and we would suggest unsatisfactory, had we as appraisers, not challenged the objectives of the project, questioned the studies and identified the dependencies. A straight rejection without the remit to devise or consider alternative solutions would have killed it off, with what consequences we can't say, whilst a qualified approval would have helped create a "white elephant" – and the world has enough of those.

Essentials for an Effective Appraisal

There are literally hundreds of aspects of a complex project that have to be examined by appraisers in order to provide an authorative opinion on which funders can rely and the above case summarises just a few. However, there are some general principles that can be extracted even from such a condensed narrative that we think funders should always bear in mind if they are to ensure that they obtain the best and, indeed, added value from their appraisers. These are:-

- Establish that the appraiser or appraisal firm has not only a core skill in a commercial discipline but has experience of working with and across all relevant technical disciplines. It is not only essential for the appraiser to be able to assess whether a proposed architectural design will meet the functional needs of a business activity but also that the proposed business activity itself is worthwhile and the operational plan realistic;

- Confirm that the appraiser or appraisal firm is independent not only of the project promoters but of any other influences on the project, such as contractors, professionals and suppliers. The appraiser must, where necessary, have the independence and confidence to challenge individuals and organisations for whom the realisation of project as presented is a cherished goal and in which they will have invested time, energy, political and financial capital;

- Don't limit the terms of reference of the appraisal to the project in isolation. None can be developed or operate in a vacuum and any factor on which it depends on directly for its proper development or operation should be investigated. There is also a strong argument for the appraisal taking into account the external impacts of the project, since any foreseeable adverse effects on matters such as contamination, noise, or even local economic conditions (eg a shopping mall taking away significant volumes of trade from a high street) may affect long term sustainability.

- Encourage appraisers to identify all risks to the delivery of the project, regardless of whether they are to be borne by the project promoters, developers or contractors, but obtain an assessment and an opinion as to the means of their mitigation. It is too easy for appraisers to list out possible risks as a method of self-protection, leaving funders to work out for themselves whether or not they are acceptable.

- Whilst appraisers cannot and must not take any responsibility for managing the development or operation of a project, insist appraisers adopt a constructive approach. This will allow a project that offers potential the best prospect of being realised even if it is not a state in which it can be immediately approved. Though not always practical or possible, appraisal should ideally be an iterative process whereby a dialogue takes place between the promoters and the appraisers until such time as a project that meets the criteria of all parties emerges.

- Involve the appraisers at the earliest possible stage of development rather than wait until it has reached an advanced state and, it is thought, all detailed queries will be resolved. By that time a significant amount of time and cost may have been incurred and a single misconception carried forward may necessitate complete reworking of the project. If practical, funders should establish a "gateway" process, whereby funds are approved as various milestones in the development of the project are attained.

Risk Reward offers short courses on the principles of project appraisal and principles of project monitoring for financial institutions.These give an insight into the work undertaken in appraisals and how FIs can best use the information they should provide.

ISLAMIC FINANCE
AN INTRODUCTION – PART TWO

IN THE FIRST ARTICLE IN THIS SERIES MARK ANDREWS, HEAD OF ISLAMIC BANKING AND FINANCE, RISK REWARD LTD, COVERED THE BASIC PRINCIPLES OF ISLAMIC BANKING AND DESCRIBED THE FUNDING SOURCES OF AN ISLAMIC BANK - OR WHERE IT GETS ITS MONEY FROM. IN THIS ARTICLE, HE WILL BEGIN TO CONSIDER THE OTHER SIDE OF THE BALANCE SHEET, THE ASSET SIDE - OR WHAT AN ISLAMIC BANK DOES WITH ITS MONEY. TO DO SO, HE CHALLENGES THE READER TO FIRST DEAL WITH THE ISSUE OF "RIBA" BECAUSE IT IS CRUCIAL TO BOTH UNDERSTANDING AND ACCEPTING THE BASIS ON WHICH A MODERN ISLAMIC BANK TRADES.

Understanding the Concept of Riba

In over simplistic terms "Riba" means "interest" and Islamic Banks may neither charge nor pay interest on their funds. Its prohibition is contentious in some quarters, especially amongst non- Islamic institutions, but the fact remains that there is unanimous support amongst all Islamic Scholars for a total ban.

This ban or prohibition is often reported in critical terms by outsiders, which is ironic given that most developed economies have banned interest to some degree or other during their histories. However a total and not just partial ban seems both draconian and anachronistic at first sight.

There is also an unhelpful "elephant in the room" which makes understanding more challenging. It is quite a big elephant actually and is normally described thus: "If it is correct that Islamic Scholars have banned the charging or paying of interest of any kind and for any reason, why is it that all Islamic bank accounts, deposits, savings plans, loans, bonds, leases, credit cards, in fact almost every Islamic product, are linked in practice to one kind of interest rate or another? This is surely either a fudge or it effectively undermines the ruling!"

The standard answer to this accusation is that "linking something to an interest rate is not the same as actually charging or receiving interest". This is obviously true in academic terms but it doesn't convert many doubters. More convincing and comprehensive explanations are required to do that and we will consider a few of these key arguments next.

First and foremost, "Riba" as originally described, is not the same as modern day interest and it is a bit confusing to connect the two directly even though the latter is now banned under Islam as if they were. Secondly, there is no direct or accurate translation from ancient Arabic into English of the word "Riba", which adds to the uncertainty. The closest modern approximation is "Usury" or "an unwarranted, unreasonable or unearned premium, excess or surplus which is neither deserved nor fair".

As mentioned earlier, the prohibition of interest, especially usury, is not confined to Islam and has a long history spanning several traditions and civilisations including our own. Whilst everyone would accept that forbidding Usury is both correct and morally right, it is less clear to outsiders why Islamic Scholars have decided to ban interest completely given the crucial role it plays in Western economies. The simple answer is that an Islamic economy was and still is different.

Quranic References

The Quran (Book of Allah SWT) refers to the term Riba several times but no definition is available and no detailed explanation is given in the practices of the Prophet (PBUH). Islamic Scholars don't know why, but they believe there are two likely reasons for this. Firstly, verses containing Riba were revealed towards the end of the Prophet's (PBUH) life and there may simply not have been enough time for the issue to be raised and explained. Secondly and perhaps more likely, the concept was so well known (like Usury is for us today), that no explanation was needed so everyone knew and agreed that Riba was wrong.

At the time of the Prophet's (PBUH) life, money was not regarded as a store of value and was not created to be hoarded for its own sake. This gives rise to one of the more powerful Islamic arguments against interest which explains more clearly the logic of the total ban.

If several people enter into a business venture together, then under Islamic rules, they must agree to share both profits and losses at the outset. Suppose each partner brings a different skill or input to the venture such as cash, labour, know how, or assets? It follows that each will request a share of the projected profits (and loss) based on the scarcity or demand for their particular contribution. In this way, everyone's return is agreed at the outset and is linked directly to the outcome of the venture.

If the venture fails, all will lose. If it succeeds, all will gain. No party can receive a minimum or guaranteed share even if the venture fails, yet this is precisely what would happen if the partner with the cash charged interest, or the partner with the know how wanted his pre-calculated profit share, regardless. In both cases the return demanded is deemed by Islamic Scholars to be unfair, excessive, unearned and unreasonable because it is not trade related and not actually earned.

The Quran explicitly prohibits Riba so anything that can be defined as Riba must be outlawed. The problem is, does this mean all interest or only some? There have many scholastic debates, including attempts to legitimize bank interest, but on balance and after what is now centuries of deliberations, the unanimous current view is that all interest is Riba and is

ISLAMIC FINANCE: AN INTRODUCTION PART TWO CONTINUED

therefore is banned. In fairness it is hard to see, irrespective of the scholastic arguments, how partial prohibitions/exclusions could work equitably in practice.

The prohibition on charging interest does not preclude using interest rates as a reference point for calculating profit returns, as long as these returns are not linked solely or directly to interest rates themselves, as this would create uncertainty or Gharar as well as Riba, both of which are forbidden.

So there is no Islamic objection to a bank using interest rates as a reference point to calculate the required profit return as long as the amount is certain, the return is fixed, the project is trade related and the bank has a genuine stake in the outcome.

This takes us neatly back to the standard answer that "charging interest and using interest rates as a reference point is not the same". It is indeed "not the same" and until a more reliable and independent mechanism for measuring returns and opportunity costs emerges, interest rates look set to retain their benchmark status.

So, if an Islamic bank cannot charge interest per se, but can use interest as a reference point on an opportunity cost basis, how does it structure its products to make a return? The answer is to provide a range of services that are genuinely profit (and loss) sharing and in which the bank's required profit return or share is calculated using bench mark interest rates, is agreed with the client at the outset but actually depends on profit generation for payment.

There is a further complication in that to be Shariah compliant all lending activities have to be trade based, must involve real goods and services, must involve actual trade, avoid any uncertainty, avoid prohibited practices and must be carried out with the utmost integrity and good faith.

Applying these rules to an Islamic bank's "lending" services has produced some complex sounding products but once these have been explored and understood it is relatively easy to identify a conventional bank equivalent.

We will cover only one in this article and that is the Musharaka, sometimes know as Shirka which translates to "sharing" and is the Islamic form of partnership.

Musharaka

Under a Musharaka one or more parties contribute to the financing and management of a Sharia compliant project agreeing to share profits and losses at the outset.

In the absence of an agreement profits and losses are shared in accordance with each partner's capital contribution. Losses are always attributed in accordance with capital contributions so the biggest stakeholders stand to lose/gain the most, which is fair.

In a Musharaka arrangement, the Islamic Bank contributes funds to the partnership in return for an agreed profit share, usually calculated by reference to short or medium term interest rates depending on the length of the partnership. The bank can be either a permanent or diminishing partner and can take security either directly or from third parties.

A Musharaka project is akin to equity finance and is almost as close to ethical and pure trade related banking as it is possible to get. The genuine sharing of profits means the bank has a real stake in the outcome of its "clients" business and forces it to concern itself very closely with the management and completion of the scheme. The fact that the scheme must be Shariah compliant means it is genuinely wealth and trade enhancing and is concerned with beneficial activities only.

All well and good so far, except that very few banks are active in this market at present. Why?

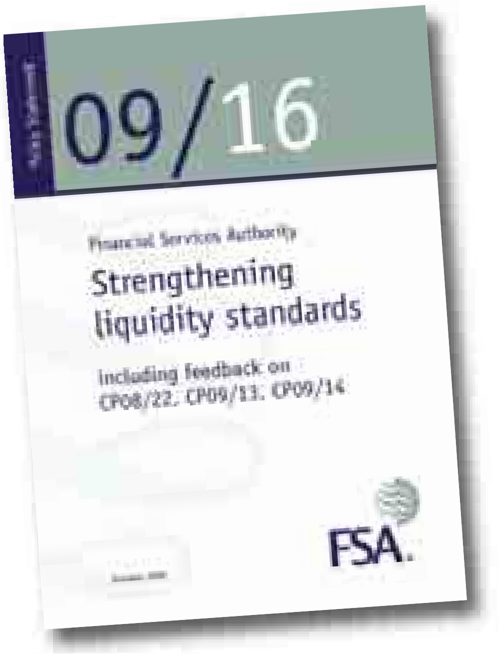
The main problem is that as with equity finance, the due diligence process for a Musharaka is considerable as is the ongoing management and monitoring obligation. The costs of this direct involvement by the bank cannot usually be rewarded adequately by the profit sharing arrangement neither can the very real risk of incurring losses be built in sufficiently. The net result is that whilst the Musharaka remains the shining example of Islamic ethics and principles, the hard truth is that it is not used that much in practice because it cannot be made to pay commercially in a modern banking environment. Other Islamic products require much less supervision, earn just as much for the bank and are therefore the preferred offerings.

In Islamic Finance: An Introduction – Part 3 (Global Risk Update Q4 2009) we will cover these preferred "lending" products and will show how Riba influences their structure. We will also explain why the two main offerings, Murabaha (means "sale") and Ijara (means roughly "lease") are the two key offerings.

THE FINANCIAL SERVICES AUTHORITY AND LIQUIDITY RISK

Introduction

This is of course a Global Risk Update, rather than one focussed on the United Kingdom and its unitary regulator the Financial Services Authority (FSA). The FSA have nonetheless published a detailed response to the liquidity crisis in their policy paper entitled Strengthening Liquidity Standards (Policy statement 09/16) issued in October 2009. We thought you would like to know how we assess the paper and what we feel could be its impact.



The Issues Identified

The FSA in the UK is not a central bank, instead it is a regulator of financial institutions dealing with both consumer matters and more general supervisory issues. They have identified the following failures of liquidity risk management and are suggesting new mitigation approaches to deal with them. That they are bound to fail and will exacerbate the next set of problems is one of the reasons why we have written his article at this time.

Issue 1: Liquid Asset Buffers

The FSA state that the first issue related to banks maintaining inadequate quality and quantity of liquid asset buffers, leading to firms' inability to liquidate them in a stress event.

The mitigation (chapter 8) is a new tough definition of liquid assets and risk-based buffer. They are requiring a stock of high-quality government bonds, central bank reserves and bonds issued by multi-lateral development banks to be held.

The new requirements are based on an initial two-week firm-specific and market-wide stress with the wider market-wide stress continuing out to three months. The cash flows need to cover the two week period and then an assessment of the additional buffer requirements will be made.
There is a problem here that should be obvious to everyone, not least of whom is the FSA. What we are to expect is that banks will hold the government securities of their home issuer. What happened when we had the 1999 problems in Russia? At the time when Russia defaulted the value of Russian bonds collapsed and a large number of banks failed. Given that the governments that are issuing the highest quality assets are exactly the governments which are the most indebted and have the greatest likelihood of failure, this concentration is extremely dangerous. To make the issue crystal clear, at exactly the time that the bank will need to realise these assets they will themselves become illiquid. Indeed if the FSA was really considering the risk assessment appropriately and the market correlations they would have required the banks to hold physical commodities, not government securities.

Then we have the idea of the two- week out flow window. We know what happens when a bank goes under stress. It is not just the cash deposits that move out, but the interbank market closes the bank out of the market. Reserve lines get withdrawn and become unavailable. There is more than just a cash outflow – indeed the cash outflow may be the least of their problems. To maintain sufficient cash to deal with this would require cash reserves that are greater than the global economy. Consequently the rules cannot work and will only put an additional cash burden onto the poor consumer.

Issue 2: Liquidity Risk Management

The next issue identified by the FSA is that banks had poor liquidity risk management capabilities (i.e. inadequate stress testing, contingency funding planning and senior management oversight). This is indeed a correct reading of the situation, which was exacerbated by the Basel Accord choosing to focus on credit, market and operational risk, making stress testing only a requirement for advanced approaches. Indeed this concern has appeared in previous Risk Reward Risk Updates.

The mitigation is that banks should introduce enhanced systems and control requirements based on the BIS paper "Principles for Sound Liquidity Risk Management and Supervision". This 2009 paper draws heavily on the previous February 2000 paper from the BIS. Put at its simplest there is little in the new paper that was not really there in the 2000 paper and, indeed, in papers that have been around for much longer.

THE FINANCIAL SERVICES AUTHORITY AND LIQUIDITY RISK CONTINUED

Clearly there is nothing wrong with the new BIS paper, nor with the earlier 2000 paper and perhaps this crisis will create the impetus for these basic requirements to be implemented. They are not in themselves sufficient however and most banks will require a much higher level of control and guidance than is suggested in the paper.

Issue 3: Liquidity risk factors
The third issue identified by the FSA is:

- Over-reliance on short term credit-sensitive wholesale funding markets;
- Large pipelines of new business with limited or no ability to fund them;
- Over-reliance for funding on securitisation markets;
- Inability to meet significant retail outflows; and
- Firms entering into ratings-based liquidity contracts without valuing the underlying option.

The new quantitative (i.e. value based) requirements include the sound of a stable door being closed. What they also will warn you about is where the next problem will come from.

They are:

- Banks should stress 100% of outflows out to two weeks and limited rollover beyond (is issue 1)
- Banks should consider undrawn commitments and the need to continue lending under the franchise-viability risk driver – which is what they do now
- Banks should diversify their funding base;
- Banks should raise their retail resilience and;
- A requirement to take into account all ratings triggers.

This is not generally very helpful considering the last three parts of the mitigation (chapter 6) and if you look at the requirements these include working out your liquidity based on a closure of the FX markets and various other uncertainties. They believe that retail deposits are stickier than wholesale deposits – whereas we believe the opposite is actually the case. They are not prescriptive, but if the FX markets are closed the diversification required becomes difficult.

If there is a real downturn of the manner suggested, government securities (indeed all securities) collapse in value and commodities increase. Reserve lines actually get withdrawn. Can you imagine being a bank with a reserve line of $1bn being called by a failing bank – would you send it? Of course you would not.

We are not suggesting that no such lines should exist; indeed we would recommend that they be obtained from institutions that are not directly linked to the problem banks economic drivers. However whether any of these can help a bank if the market decides to kill it is a different matter. Beware the curse of Breakfast television – the bad press can kill you by lunchtime.

Issue 4: Group issues
The FSA stats that another issue was UK branches and subsidiaries of foreign groups which maintain global liquidity pools that can be disadvantageous to UK deposits. The mitigation here is that principles of adequate liquidity and self sufficiency should be implemented where necessary, together with enhanced home-host regulation.

Given that capital tends to either migrate to the home regulator or become sticky when either a firm or a bank goes under stress, these rules are clearly valid – but will prove hard to implement particularly in branches.

Issue 5: Data Issues
The final issue raised by the FSA is that they have insufficient data to assess properly the firms' liquidity positions or to form sector and industry wide views. They are requiring more detailed reporting of liquidity positions.

Of course at the heart of all of this, much of which is welcomed, is a major issue. Liquidity does not tend to go wrong on average, or for the last reasons that we have seen. The next crisis could easily result from a major economy being forced to go to the IMF or defaulting. The rules here, being essentially backward looking, could miss the real issue. What is needed, in addition, is much better behavioural analysis within the banks themselves, together with embedded economic analysis.

The economic analysis is the leading indicator which when combined with appropriate stress testing could actually lead an issue enabling avoiding action to be taken. However take a simple case. Do you have a mortgage? Who were you working for when you took the mortgage out? Have you told the mortgage provider of any of your changing circumstances? In the absence of such basic data the behavioural analysis becomes less effective in predicting the future and consequently cash flow prediction is even more difficult.

This is a long and detailed paper which I commend to all of you to read – where the FSA goes today your regulator may go tomorrow. The FSA have indicated these rules, which will cause a significant burden to banks, will only be implemented once the UK is clearly emerged from recession. That their implementation will probably cause an immediate return to recession, inappropriate banking practices that will exacerbate the next crisis and increased charges to the customer appears not to really matter much.

WHEN THEY CALL YOU – WHO ARE YOU GONNA CALL?

A RISK PRACTITIONER'S GUIDE TO MAKING GOOD CREDIT RISK MANAGEMENT HAPPEN

Mary Phibbs, ACA, a Chartered Accountant, has held Group Chief Credit Officer and other senior credit and risk management positions at ANZ Standard Chartered Bank, KPMG, PWC, National Australia Bank and Commonwealth Bank of Australia and is passionate about credit and risk management. She is adept at explaining and sharing practical understanding, project management and change management solutions when charged with rolling out a credit risk programme within a bank. Mary contributes this as the first in a series of articles for risk practitioners whose role is to embed sound credit risk governance and practice in their organizations.

You are the Head of Risk or Chief Credit Officer for a medium to large sized Financial Institution and so far you have done a great job. You have put risk and good risk governance high up on the agenda for your organization. From the board down they are aware of the lessons and implications of the credit crisis, of increased regulator intervention and of many new rules. Everyone agrees that sound risk management and governance has to be embedded deep into the organisation's culture processes and procedures and you are the person for the job.

The Challenge

Congratulations and now you have a challenge: what does all this mean in practice for your organization?

For instance,

- How will you put in place controls around something you haven't defined?
- How will you record risks when you can't afford to upgrade the system?
- How will you get people to adopt what they don't understand?
- How will you explain it to the Board?
- How will you know when you have been successful?

You know that good risk or credit risk management does not happen in isolation of the business. Unfortunately in some organizations, the necessary establishment of risk as an independent function has meant that there is not always the recognition that management of risk occurs across all business activities and is not just the purview of the risk function.

The quality of business being written and the level of losses are not just the responsibility of the credit department. Conversely the credit risk function has a role to play in each stage of the business cycle from planning and product design through to collecting the profits not just in sanctioning transactions. Additionally, from the outset good risk management will not become embedded in the organization unless you bring people along with you and they will not be open to change (If change is needed) unless they have a compelling set of reasons to do so.

For example, the finer points of the Turner Review may not present such a compelling reason for change to your branch loan officers as it does to the Chairman of the Board. So early on it's a good idea to get a message across that everyone can start relating to.

A suggestion would be to communicate how good risk management will benefit everyone in the organization by enabling business sustainability and growth through:

- Efficient and effective decision making balancing risk and reward within the context of a well defined business strategy and risk appetite
- Containment of costs and losses as well as increased revenue from exploitation of new business opportunities
- Ensuring that business decisions are made and the business operates in line with a defined framework of values and principles and appropriate standards of risk management and governance are met.

You will have to put this into your own words, of course, as you will know what best suits your organization and culture. A hint: you really do have to connect with as many people as possible when you get it out there as they won't hear your message until they know you care, so think big. Having started to paint a picture of

WHEN THEY CALL YOU – WHO ARE YOU GONNA CALL CONTINUED

where you are headed in broad terms the next step is to work out where you are at present. A great way to do this apart from looking at what documentation, reports internal and external etc you have is to actually ask a good cross- section of your key stakeholders. This will also have the benefit of engaging a wide variety of people into what you are trying to achieve early on. It may include the board and the regulator but don't forget the more junior members of your team and the sales people and/or relationship managers and loan

officers who have direct contact with the customers. These people usually have a really good idea of what is going on your organization and it's just that so far maybe no one has thought to ask them. Try and think laterally about the type of data that will be helpful, e.g. if staff engagement data is available a low score will give you a fair indication that the risk culture will be wanting. The same goes for customer satisfaction surveys. Further, high turnover in credit risk roles could also indicate issues.

Getting Organised

To more easily pull it together at the end it is best to have some kind of checklist and structure to the questions and areas where you are going to take a closer look. The areas to be considered usually fall under four broad headings:

1. **Strategic**
2. **Structure and framework**
3. **Process and portfolio**
4. **People and capabilities**

The actual questions and their weight again will depend on your organisation's circumstances, including your regulatory environment. Be clear which elements are mandatory, i.e. prescribed by law and regulation or regulator endorsed reports such as the Walker review in the UK, which questions are more about best practice and which are internal and in line with strategy or the brand value (e.g. a customer charter). Be aware also that although there may not be rules on, say, the appropriateness of data, a regulator may have difficulty in seeing how a firm can have effective risk management as required under its rules without the appropriate data being available.

The answers to the questions will also help you identify potential problem areas early on so you can take action quickly. Also it is a good idea to keep the questions broadly focussed initially rather than limiting them to those you believe solely relevant to credit risk. Risk types and business processes are closely linked. You may discover for instance that in order to improve the credit quality of the book the collections process or the documentation process may need to be addressed and neither process may be the direct responsibility of the credit risk function.

1 Strategic

Mission and objectives

- Is there a mission statement for the business and objectives?
- Is there one for the credit risk function? Are they consistent?

Strategic Plan

- Does your organization have a fully integrated planning process from 1 to 3 years?
- Is credit risk an integral part of the process? Are losses planned for and if so how?
- Is there a clear set of priorities for the business and likewise credit risk and are both consistent?

Risk Appetite

- Is the amount and type of credit risk that the organization is willing to bear clearly articulated?
- Does the Board approve it?
- Is it well understood?
- Does it inform business decisions?
- Is there a balance between risk and reward at every level of decision making?
- Does it inform portfolio management?
- Does it align with business strategy and expected returns? Are there formalised risk triggers?

Capital management

- Whose job is it to manage?
- Who provides oversight?
- Do you have a Capital Management Committee?
- What data is it based on?
- What is the extent of your stress testing?
- How is capital apportioned?

2 Structure & Framework

Committees

- Is there a separate Risk Committee?
- Do you have a Credit Committee?
- Who sits on them?
- What are their powers?
- Who are they accountable to?
- What is in their charter?
- Who reports to them?
- Who measures committee effectiveness?
- In regards to the charter for a risk committee for example one would expect some or all of the following elements to be present:
  - Members all or mostly independent non executives
  - Minimum meetings per year
  - Overall authority to determine risk framework
  - Powers to delegate
  - Establishes risk appetite and recommends to the board
  - Recommends changes to the board on risk strategy and policy
  - Overviews risk control and assurance framework
  - Monitors risk exposure and profile against risk appetite
  - Monitors and reviews risk exposures, issues and risk reporting

Structure

- Is the risk function independent?
- Who does the CRO and CCO report to? the CFO? the Risk Committee? The CEO?
- Who determines the remuneration of the CRO and the CCO and the rest of the risk team? (For example, if the business controls this then one might have to question the ability of the function to be truly independent).
- Do you have an internal audit function?
- Who performs risk assurance?
- Is the credit risk function and process audited?

Policies

- Is there a full suite of policies covering all aspects of the credit risk framework (such as delegations, exposures, assessment criteria, loan to value criteria, collateral, write offs etc)?
- Who monitors and reports that these have been adhered to?

3 Process and Portfolio

Approvals & Process

- Is the credit approvals process well articulated are responsibilities and accountabilities well defined and aligned?
- Are approval authorities based on actual risk exposure?
- How is this measured and monitored?
- Is there a risk based approach?
- Are approval authorities attached to roles or the capabilities of the actual people in them?
- Is there a standard applications form? a standard credit submission form?
- What are the minimum criteria for approval?
- Who determines pricing?
- Does risk have a say in the return required for the risk being undertaken? In product design? In due diligence?
- Who monitors that loan covenants have been adhered to?
- Who approves and monitors overrides and exceptions?

Models

- What is the extent of credit model usage in your organization?
- Who builds and monitors their performance and are these functions separate?
- Does the business have any role in their oversight?
- What data do they use? Is it adequate?

Data

- Is the credit data sufficient to allow for estimation of default probability over a cycle?
- Is it detailed enough to allow for proper tracking of underlying drivers of risk in the credit portfolio?
- Can you aggregate all exposure types to each obligor, each industry type etc?
- What information gets reported to management and the board, who compiles it?
- Who analyses it/ who maintains it?
- Is it independently maintained, reconciled and audited?

Systems

- What exposure management and risk reporting systems do you have in place?
- Are they the same systems you use for financial reporting and if not can you reconcile between the two and who performs the reconciliation?
- Are your systems appropriate for the level of data you have available and for how your organization operates and requires information?
- If you rely on spreadsheets, which may be more appropriate to the size of your organization, who builds and maintains and monitors them?
- Who approves system and spreadsheet changes?

WHEN THEY CALL YOU – WHO ARE YOU GONNA CALL CONTINUED

4 People and Capabilities

Increasingly there is the expectation from regulators that it is the firm's responsibility to ensure that all persons in control functions and in significant influence functions are fit and proper for the role. Further changes are expected to tighten the Approved Persons – Significant Influence functions regime in the UK, for example, with many other jurisdictions likely to follow suit.

The implications for the required capabilities of individuals in the credit risk function and those overseeing business writing are obvious. Areas to be addressed in any assessment would include role clarity, understanding of credit principles and practice in risk and the business, accountability for the same, extent of ongoing training in credit Basel and regulatory requirements, analytical capabilities, understanding of credit principles, requirements etc in all oversight functions including board and business committees.

The regulators have also expressed a strong interest in remuneration policies particularly in regards to bonuses. However, at a less visible level it is apparent that there is a growing interest in remuneration in general and how risk management functions particularly in credit sanctioning are being treated. An imbalance between those with significant influence on the risk:return equation where it may lead to a greater incentive to write the business rather than to its quality is likely to draw critical attention.

Ready to get started?

The above questions are just an example to get you started. Do bear in mind that you probably do not have many weeks in order to pull a great deal of information together. You will just have to gather what you can in the time available and then like any good credit risk professional exercise judgement.

Let's summarise. At the start of your journey to embed good credit risk and governance and practice into your organization it is a good idea to have a general idea of where you would like to get to and then to take stock .

Once this is achieved you can begin to formulate a plan of what needs to be done and when and what resources will be needed.

The approach of looking at documentation and talking to as many stakeholders as you can have the advantage of helping to enjoin everyone to the cause. You will have an understanding of their needs and be able to get greater understanding and commitment from them as to what in your professional judgement needs to be done. True lasting change will not be sustained by forcing it on people; you will have to win hearts and minds by being open, inclusive and accepting feedback.

Don't forget

You may not get the perfect information. You will need to use judgement and make recommendations as to ideal conditions, timing and agreements. **The questions will be the framework of what is ideal.** You will be able to match that against the current situation. From this will emerge priorities for action. Keep everyone informed of the outcome and your recommendations. You will need their support and ownership.

In coming articles we will discuss some of the key areas above in more depth. Taking Risk Appetite, for example, we will look at the practicalities of quantifying it for your organization embedding it into decision making, reporting and explaining it to all your stakeholders so that it has relevance to them.

RISK REWARD

MANAGE THE RISKS, REAP THE REWARDS

60 Moorgate
London EC2R 6EL
United Kingdom

Office hours: London (GMT)
09.00am – 19.00pm Monday – Friday

telephone: +44 (0)20 7638 5559
fax: +44 (0)20 7638 5571
email: info@riskrewardlimited.com
website: www.riskrewardlimited.com

For further information please contact:

Dennis Cox – CEO
telephone: +44 (0)20 7638 5558
email: DWC@riskrewardlimited.com

Lisette Mermod – Commercial Director
telephone: +44 (0)20 7638 5559
email: LM@riskrewardlimited.com

Nick Barcia – New York Office
telephone: 1-914-619-5410
email: NB@riskrewardlimited.com