



# GLOBAL riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

APRIL 2011



## THE BRIBERY ACT 2010

### Also in this issue

- WHO MANAGES RISKS BETTER – BANKS OR INSURERS?
- ARE AUDITORS BREAKING COMPANY LAW RULES
- REASSESSING AND UPDATING CREDIT ANALYSIS AND MODELS
- THE CHANGING GLOBAL FINANCIAL MARKET
- THE IMPACT OF GETTING REGULATION WRONG

## Dear Subscriber

So we have had yet another quarter with major regulatory changes within a difficult economic environment. risk management and compliance within financial services. In the UK the Bribery Act is finally coming into force and this should be a concern to British companies worldwide and anyone doing business with the UK. In this month's lead article John Horan provides an analysis of the Act and Raises serious concerns about its implementation and overall impact. These changing rules have also raised the profile of money laundering deterrence. David Blackmore, Director of Financial Crime at Risk Reward provides a review of the key international developments in financial crime that anyone in the industry needs to be kept up to date.

The global regulatory frameworks for banking and insurance are both going through significant change. In insurance we are seeing a pushback against Solvency II as it is being implemented in the UK. In banking Basel III is trying to build on the basis of Basel II to come up with a better way of regulating banks. We have significant doubts regarding much of what is proposed. In this issue we consider who regulates risk better - the banking industry or the insurance industry? Cormac Butler in his article has reviewed the question as to whether auditors are in fact breaking the law following the House of Lords judgement and starts to question the basis of the current role.

Three additional articles look at what is happening in the economic and regulatory markets. Tracey Williams concludes his three-part series of articles looking at Reassessing and Updating Credit Analysis and Models which given the lack of relevant historic data is a matter of key importance. The Changing Global Financial Market speculates on how the market is going to change. Read in conjunction with the piece on The Impact of Getting Regulation Wrong you will see that there are real concerns that the current market paradigm will result in a major change in the stance taken by global financial institutions leading to new entrants to the market and new ways of doing business.

2011 looks likely to be a period of sustained uncertainty which will be seen as the period before the commencement of the next stage of the economic cycle. The only question is whether this is likely to be benign or a real problem. As we start to see the impact of reduced government spending in the submerging economies of the world on global financial activity then a reduction in global demand can be anticipated which may at some stage lead to growth. The there is the likely scenario based on government lethargy and the impact of local and international unrest suggesting more turbulence to come. We shall I am sure return to these theme is future issues of this Risk Update and will seek to keep you informed through regular postings on the Risk Reward Global Risk Forum on LinkedIn which you are all welcome to join.

With best wishes



Dennis Cox BSc, FSI, FCA  
Chief Executive Officer



## INDEX PAGE

THE BRIBERY ACT 2010	3
WHO MANAGES RISK BETTER – BANKS OR INSURERS?	5
ARE AUDITORS BREAKING COMPANY LAW RULES	7
REASSESSING AND UPDATING CREDIT ANALYSIS AND MODELS	9
THE CHANGING GLOBAL FINANCIAL MARKET	12
THE IMPACT OF GETTING REGULATION WRONG	14



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### TO THE EDITOR

Do you have risk issues in your organisation or region you would like to share? Email your thoughts to the Editor at [DWC@riskrewardlimited.com](mailto:DWC@riskrewardlimited.com)

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# THE BRIBERY ACT 2010

*John Horan, Director of CAML Global Limited, has contributed this article to address the principles of the long awaited UK Bribery Act and questions how British firms, worldwide, will adapt their business practices to conform to the mysteries of Sec 7 and the need for a risk-based approach.*

**Finally it has arrived! The much trumpeted Bribery Act 2010 will come into force on 1st of July 2011. After much angst and scaremongering it is with us. Additionally much of the rumours and bluntly falsehoods about it stifling business have also been laid to rest by the guidance issued by the UK Ministry of Justice.**

In his foreword to the guidance the British Secretary of State for Justice Kenneth Clarke says the legislation and its guidance is “...largely common sense...proportionality”. He goes on to say “no one wants to stop firms getting to know their clients by taking them to events like Wimbledon or the Grand Prix” These are all things that Risk Reward’s Financial Crime Team have been reminding clients of since the Act was first drafted. It is also nice to know that as a by product of entertaining clients you are actually practicing KYC (Know Your Customer) and thereby complying with the Money Laundering Regulations. Two birds with one stone!

The guidance is based on six guiding principles and emphasises it is not prescriptive nor designed to be one size fits all. Now I know that many of our clients prefer a prescriptive approach it takes the pain out of decision making. However I firmly agree with the non prescriptive approach as it allows your firm to tailor your policies and procedures to fit your business model and thereby minimise costs to you as a business. In this economic climate that has to be worth a little headache and pain.

## The six principles are

1. **Proportionate procedures**
2. **Top level commitment**
3. **Risk Assessment**
4. **Due diligence**
5. **Communication (including training)**
6. **Monitoring and review**

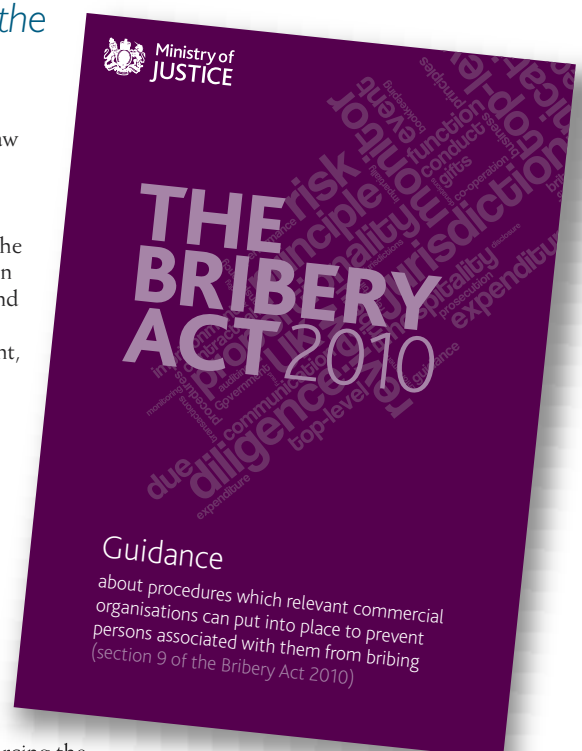
Not surprisingly with a non prescriptive approach in common with the Anti Money laundering legislation there is a need for a risk based approach. Consequently there is an ongoing need to monitor your procedures and business relationships as nothing is static.

The area which is causing considerable concern to most firms is the Section 7 offence of “Failure of commercial organisations to prevent bribery”. It is this offence that the

regulators and the law enforcement community will undoubtedly focus their attentions on the basis that an easy win is a good win, a sound principle in any business environment, if not particularly helpful. Aon of course fell foul of this type of enforcement when the FSA levied a seven figure fine for failure to have proper procedures in place. Interestingly the guidance ensures that there can be “no two bites of the apple when enforcing the Bribery Act”.

A significant worry was that having failed to secure a conviction on an offence under Sections 1-6 the prosecuting authority would revert to an offence under Section 7. This has been specifically vetoed in the guidance. Sounds good? Do not be so sure. If a possible prosecution under Section 1-6 seems to be less than a sure thing, the prosecutor may go for the potentially easier to prove Section 7, abandoning prosecution of an actual offender knowing that a failure in Section 1-6 negates any possibility of a Section 7 prosecution. The Section 7 offence as the first offence prosecuted does not require as a prerequisite conviction under Sections 1-6. It is a standalone offence. My advice is be careful. **Get your procedures right NOW.**

Another issue that concerns firms is the extra territorial nature of the legislation, there is a feeling that this is something completely new. In many ways of course it is. Strictly speaking the concept has been with us for some time. Travelling abroad for sex tourism is already an extra territorial offence under the UK Criminal Justice and Immigration Act 2008. As long ago as 1843 liberal politicians and others sought to extend the concept of extra territoriality abroad to areas where slavery on British owned property continued, the



## THE BRIBERY ACT 2010



so called Brougham's Act. It met with limited success I have to say. Business interests and by extension the protection of profits was king then, the Cuban and Brazilian slave mining continued under a different guise.

In dealing with extra territoriality it has more than one dimension. United Kingdom courts have jurisdiction over Sections 1, 2, and 6 offences committed in the UK and offences committed outside the UK where the person committing them is a UK national or ordinarily resident in the UK. A very broad approach indeed. Naturally this extends to a corporate entity in the UK and a Scottish partnership. Seems simple enough?

**What is missing?** Yes you have guessed it good old Section 7. Again in dealing with extra territoriality we see how dangerous this section is. Unlike the other sections no close connection with the UK is necessary to commit this offence.

Provided conduct which amount to a bribery offence is committed by a person or entity outside the UK and the organisation committing the Section 7 offence is incorporated or formed in the UK, and here is the interesting bit or the organisation carries on a business or part of a business wherever incorporated an offence is committed. However yet again the guidance adopts the sound principle of calling for a common sense approach.

Another area causing considerable concern to businesses with an overseas dimension was the failure of government to exclude facilitation payments from the offences of bribery unlike the United States FCPA which does cover it. Here too the guidance goes some way to take the sting out of the legislation recognising cultural differences and the need on some occasions to make "facilitation

payments" to protect against loss of life etc. The defence of duress should come into play here and may prevent conviction if not necessarily prosecution. In all scenarios where bribery offences are alleged to have been committed prosecutorial discretion lies at the heart of the decision making process. The guidance also emphasises that part of that decision making process will be is the prosecution in the public interest. So if the bribe secures significant work or contracts for what is essentially UK plc does that make a difference? Just a thought.

*For more information about the Bribery Act and enforcement issues please contact John Horan via Kathryn De'Ath, Financial Crime Team Leader at [kda@riskrewardlimited.com](mailto:kda@riskrewardlimited.com)*



# WHO MANAGES RISK BETTER – BANKS OR INSURERS?

*At a recent industry event in London, Dennis Cox, CEO, Risk Reward Ltd, participated in the debate to consider this rather interesting question. This brief article further explores the issues raised, how each industry evolved their own risk management and asks if it is really about enterprise risk after all?*

**Who manages risk better?** In answering we need to consider both where the two streams of risk management are, together with the impact of changing regulation within both markets. Banking and insurance risk management both have been around for many years yet each was good at some things and not-so-good at others. Perhaps what is most unusual is that elements that one stream was good at the other might almost ignore, or vice versa. Prior to 1990 neither banks nor insurance companies really had implemented effective enterprise risk management. Within banking "risk management" was almost seen as being synonymous with corporate or personal credit risk management. The common approach normally adopted within insurance was to focus on actuarial risk.

This led to significant differences between both risk management streams. Banking tended to focus on the now, looking towards expected credit losses to develop effective product pricing. For insurance given that actuarial liability by its nature tends to focus on unlikely events it is perhaps unsurprising that these risk managers tended to focus on the relevant tail liabilities for those risks that were being covered. Both streams therefore effectively focused on the risk attached to their primary income source. Looking at the relevant income and risks within these two industries, the most important might be seen as:

	Income	Key Risk
<b>Banking</b>	Interest income	Credit default
<b>Insurance</b>	Insurance Premiums	Increased event risk

## The Problem

The challenge here is that by focusing on these specific risks, others are left outside of the discussion. Typically focusing on a single risk could easily lead to suboptimal risk management and loss of income or at worst the firm. Within both insurance and banking various other risks would be managed within different areas, for example:

RISKS	MANAGEMENT AREA
Operational Risk	Operations
Liquidity Risk	Treasury
Counterparty Credit Risk	Often omitted
People Risk	HR
Strategic risk	The CEO
Reputational risk	Often Omitted

This then leads to the obvious conclusion that neither banking nor insurance actually were as good at enterprise risk management as engineering or manufacturing. The question then is why?

## Insurance Industry

The domination of the actuarial profession led to the idea that actuarial risk equated to risk management. Of course that is not really the case since the actuarial risk calculation is essentially looking at profitability for the firm. It considers

## WHO MANAGES RISK BETTER – BANKS OR INSURERS?

the risk attached to tail liabilities offsetting additional exposure through reinsurance as appropriate.

What Solvency II is seeking to achieve is the consistency of risk modelling in the insurance industry that Basel II seeks to achieve in the banking industry. Through bringing an enterprise risk culture into the business Boards of insurers are able to understand the combined risks of the business. This will improve decision making and ultimately profitability while reducing earnings volatility.

**There are still limited true ERM people available and the greatest challenge to both banking and insurance is to develop such resources.**

With the impact of the actuarial profession there was always advanced modelling within insurance for the income generative areas. Other areas were poorly considered. Operational risk was seen as operations risk and became the responsibility of the Chief Operating Officer perhaps by default. No modelling was done and in that are perhaps bizarrely no consideration of unexpected loss was taken into account. The non-operations part of operational risk including legal and human resources risk, were not addressed.

Another area that appeared to get missed was counterparty credit risk. This is the risk related to

working with financial institutions. Some insurance companies almost ignored this risk setting what might at best be termed facilitation limits to deal with them. Other firms relied exclusively on external ratings to develop limits failing to recognise the inherent limitations that such an approach would have. Finally some did not have any limits at all and just carried out business.

In summary, good modelling in some areas, but a paucity of work in other areas.

### Banking Industry

Banking risk was always seen as being synonymous with credit risk. Credit risk was then also seen as an art rather than a science so limited modelling was conducted. Again prior to Basel 2 many firms did not undertake enterprise risk management and you can still see some of the legacies of this in the reporting lines adopted by banks now. Too frequently the risk committee does not have all risks reporting into it and accordingly it cannot consider the full risk environment when developing its solutions.

The development of market risk as a science in the 1980s and 1990s led to highly qualified modelling professionals joining the banking profession. A disconnect from the risk management team and the Board frequently then developed with limited understanding of the impact of risk mitigation strategies making it onto the Board agenda. The use of models within market and liquidity risk became a replacement

for risk management as opposed to tool of risk management, that is, the end rather than the means.

This actually resulted in risk management becoming separate from the business rather than part of the way we do business. This separation caused risk management functions in banks to look towards providing data to the regulators as opposed to actually supporting the business. The failure of many banks to successfully embed a risk management culture into the business resulted in many risk management projects not adding any value to their firms. It is with Basel II and the 2003 sound practices paper that many banks started to recognise the issues and deal with the consequences.

So, we asked, which was better? Insurance perhaps and if not then banking. Both had much to learn from engineering or manufacturing which embedded risk management as part of their quality driven cultures. Neither insurance nor banking chose to do so, which is perhaps at the heart of the recent crisis.

### The Future

Clearly there is a convergence between insurance and banking risk management. In many ways enterprise risk management is not industry specific, rather it seeks to identify, model, measure, mitigate and report the risk profile of the firm. In those terms the identification of the total risk profile on a consistent basis using modelling that is understandable to the senior management team is not in any way an industry issue.

The development of a qualified risk management industry staffed by enterprise risk management ('ERM') professionals is currently underway. There are still limited true ERM people available and the greatest challenge to both banking and insurance is to develop such resources. The importance of the qualifications issues by the CISI (Chartered Institute of Securities and Investment UK) and PRMIA (Professional Risk Management International Association), for example, is clearly paramount in achieving this. But many people will start with a skill in a single area – perhaps actuarial science or credit risk – then become a Head of ERM. Training to enable true comfort in all areas of risk management should be required prior to the role being undertaken but frequently this is not the case.

Until we are able to develop sufficient global ERM talent to support the global financial market then we have to expect more problems to appear. Further as the techniques become more complex, driven by increasingly confusing regulation, the demands on senior management and non-executive directors also increases. This increasing demand on risk management will remain a challenge for the next decade or more.

*Dennis Cox invites your feedback or questions.  
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# ARE AUDITORS BREAKING COMPANY LAW RULES?

*Cormac Butler examines whether flaws in the International Accounting Standards contributed to the Operational Risk that led to many bank failures.*

**Evidence provided recently to the House of Lords who held an inquiry into the role of auditors in the banking crises has raised a few concerned eyebrows as it suggests that auditors are not complying with Company Law for which criminal penalties apply and their failure to do so may have contributed to the banking crises that engulfed what were once safe banks in the UK and Ireland.**

Indeed some commentators argue that if this evidence stands up, auditors may face negligence claims and in extreme cases, a criminal investigation. The House of Lords heard that although the International Financial Reporting Standards (IFRS) allow insolvent banks to conceal or at least delay recognising losses company law certainly does not. Auditors must therefore not only comply with IFRS rules but give appropriate warnings to shareholders and investors that their bank may contain hidden losses or artificial profits – or face possible negligence claims.

There are significant differences between published accounts that meet the requirements of the International Financial Reporting Standards (IFRS) and statutory accounts that meet company law rules. Accounting experts have advised the inquiry that many auditors allowed banks to ignore prudence and to prepare published accounts which suggested that banks were viable and profitable when in reality, they were on the brink of a bailout. Prior to the IFRS which many European banks adopted in 2005, auditors and accountants were forced to apply the prudence concept when preparing accounts. Accountants revealed losses immediately but delayed the recognition of profits until they were 'realised' i.e. the asset

producing the profit was sold. The IFRS were criticised for abandoning the prudence concept, allowing banks to conceal losses and record profits prematurely.

According to Professor Stella Fearnley who gave evidence to the House of Lords: **"Because of the increasingly specialist nature of banking business, a Statement of Recommended Practice (SORP) was issued by the British and Irish Bankers Association in the decade prior to 2005 and the introduction of IFRS. The SORP set out detailed accounting methods for banks which all banks were expected to follow. The SORP was entirely consistent with Company Law and set out how to account for mark to market and loan loss provisioning."** Professor Fearnley went on to observe that: **"The UK and Ireland, with the most comprehensive introduction of IFRS and IFRS style accounting in banking companies, have had the most non-investment bank collapses in the EU. There are now some concerns that FRS 26 does not match up with the UK capital maintenance rules and the requirement for prudence, which still applies under UK GAAP."**

If this evidence stands up, then the IFRS standard-setters, the International Accounting Standards Board will face severe criticism for promulgating accounting standards that encourage auditors to break company law rules. Many auditors have relaxed on the false assumption that by complying with IFRS, auditors automatically comply



**"The UK and Ireland ... have had the most non-investment bank collapses in the EU."**

*Professor Stella Fearnley*

with Company Law. The problem possibly stems from the fact that IFRS rules are copied from the US standards. Unlike the UK and Ireland however, there is no company law legislation in the US that prevents auditors from allowing banks to hide losses or claim to be solvent when in fact they are bankrupt.

According to Professor Fearnley **"Just after the regulation was issued in 2002, the Enron scandal broke and the US standard setter, the Financial Accounting Standards Board (FASB)**

## ARE AUDITORS BREAKING COMPANY LAW RULES?

**was heavily criticised. A member of the IASB was then appointed as chair of FASB. IASB then announced later in 2002, without public consultation, that it was going to converge its own standards with those of the US FASB”.**

This accounting change may have encouraged reckless banking activity. Banks for instance offering dangerous 125% mortgages at cheap interest rates almost certainly did not apply the prudence concept and possibly hid losses which is allowed under IFRS, but not under Company Law. Bankers who flocked into complex structured products and securitisations, often never bothered to value them once purchased and where they did, they used assumptions that in effect allowed them to record a profit under IFRS when in reality they suffered losses which were hidden. In Ireland, banks are still accused by the Irish government of

auditing profession. The former Chancellor of the Exchequer Nigel Lawson has expressed surprise that no auditor was yet sued for the banking catastrophe. More recently, the former president of the Institute of Chartered Accountants Peter Wyman claimed that as far as bank audits were concerned, the IFRS rules were ‘not fit for purpose’.

He states, **“The rules allowed banks to pay dividends and bonuses out of unrealised profits – from profits that were anything but certain. The system is still in place now – we can’t tell if similar problems are building up because there is no requirement to separate realised from unrealised profits”**

Wyman is effectively putting the rest of the profession on notice that they are knowingly using accounting rules that don’t work. This could expose

record profits and therefore pay bonuses on loss making transactions using IFRS rules. The result is that banks have lent recklessly, engaged in dangerous takeovers and invested in complicated lethal weapons of mass destruction, as described by Warren Buffett, which they don’t understand. These instruments were kept off balance sheet by accountants who claimed that they were complying with IFRS and American accounting standards. If banks pay bonuses to people to wreck a bank in this way, the Operational risk is clear.

There is a negative correlation between bonuses and good risk management practices. Regulators will penalise banks who take on too much leverage and risk but as long as bonuses are paid for reckless lending bankers will buy leveraged structured products and keep them off balance sheet yet, the artificial profits from these transactions flowed into the Profit & Loss under flawed IFRS. Traders and bankers received bonuses, bonuses they would have been denied had auditors reported or even understood the requirements of IFRS 7 on financial risk disclosure. Bankers therefore are tempted not to measure risk properly, it’s not good for bonuses. However, to hoodwink accountants and regulators, they give appearances that they are doing so.

Few in the profession could argue against the view that significant changes in the accounting rules are urgently required. Accountants will have to try and understand the economics of the underlying transactions and therefore need to enhance their training and knowledge of financial instruments along with a realistic appraisal of what drives operational risk.

*Cormac Butler is a consultant on Regulatory risk and financial reporting and has recently written ‘Accounting for Financial Instruments’ published by John Wiley & Co. He is also the author of ‘Mastering Value at Risk’ published by FT Pitman.*



continuing to hide losses. Indeed the chairman of the Irish Central Bank has criticised the accounting standards that allow banks to conceal losses. IFRS contributed to the problem that bankers paid themselves bonuses based on artificial profits when in reality, they engaged in reckless lending which brought the banks down.

The chairman of the Irish Central Bank is not the only person criticizing the

accountants to negligence claims unless auditors warn shareholders that bankers are possibly hiding losses or recording profits based on biased judgements.

While risk experts, analysts and commentators have written reams of articles on Operational Risk few if any have highlighted the greatest source of Operational Risk since 2005. Bankers’ bonuses are calculated on flawed information. Bankers are allowed to



# REASSESSING AND UPDATING CREDIT ANALYSIS AND MODELS

*After a financial crisis, there is always room for improvement in corporate credit-risk analysis. Tracy E. Williams, former managing director at JPMorgan, makes recommendations for model updates and shows how analysis can be forward-looking and anticipate unforeseen risks. The final article of three parts examines how to look for signals of insolvency, excessive debt levels and trouble lurking off-balance-sheet.*

## **Solvency: Looking for Weak Signals**

All discussions of liquidity, cash reserves and working capital lead to an examination of solvency. Emerging from a crisis, analysts will ask why they didn't see the signals of companies that defaulted or went bankrupt. There have been times when a company is deemed insolvent, despite satisfactory earnings, cash on hand, and a balance sheet without much of a debt burden.

Insolvency sends signals, although they are sometimes difficult to detect. Analysts should suspect a degree of insolvency if there is a combination of any of the following:

1. The company has no ability to refinance short-term debt,
2. A swift, significant short-fall in cash reserves occurs,
3. Most of its short-term lenders demand immediate paydown with little notice
4. Financial assets collapse in values,
5. Interest rates increase sharply with little evidence the company has hedged against the risk,
6. Third parties emerge from nowhere to stake their claims, or
7. The company has unusual, sudden obligations arising in unconsolidated subsidiaries.

Like liquidity, there is no one way to measure insolvency. Abundant factors contribute to it. Post-crisis, analysts should address it and hunt for weak

signals. An important first signal? If liquidity, measured by cash, marketable securities and immediately available funding sources, is substantially less than the sum of short-term liabilities,

assessment of whether the balance sheet is overburdened with leverage. Companies have been able to survive downturns or withstand unanticipated risks if they have sturdy balance sheets



current interest expenses, other demand payouts, or other unanticipated liabilities, then the analyst should raise a flag.

## **Capital Structure: Fine-Tuning the Mix**

For many, capital structure is about the debt-equity ratio and perhaps an

anchored by the right capital structure. Post-crisis, risk managers must examine whether the structure is appropriate for good times and bad.

**What is the right capital structure?** A high debt load doesn't imply a faulty capital structure. The appropriate mix of current and long-term debt and

## REASSESSING AND UPDATING CREDIT ANALYSIS AND MODELS

equity contributes to the right structure. But the evaluation goes beyond the right mix and should incorporate the following:

1. **Industry-related structure:** Is capital structure appropriate for the company's industry (e.g., financing institutions, industrial companies or service companies)?
2. **Tenor matching:** Are assets and liabilities matched properly? Are fixed assets funded by long-term debt and/or capital?
3. **Currency matching:** Are assets and liabilities by currencies matched properly (or hedged sufficiently) to minimize foreign-exchange risks?
4. **Interest payments:** Is debt structured such that interest expenses (floating and fixed) are matched properly with cash flows from operations or from interest earned on certain assets?
5. **Debt maturities:** Is debt structured such that principal payments are matched properly with cash flows?
6. **Debt burdens:** Based on current operations or in a downturn scenario, at what point does the debt-equity ratio become too much of a burden, when the company struggles to meet principal and interest payments and/or when short-term lenders begin to pressure for paydowns?
7. **Debt content:** If the amount of debt is appropriate, is the make-up of debt optimal?

#### Debt: The Good and the Bad

Risk managers might conclude that the amount of debt on the company's balance sheet is manageable and is rationalized. Sometimes, however, they neglect to dissect the make-up and details of complex debt structures. A torrent of risks may exist beneath a single line of liabilities on the balance sheet. Debt structures today have numerous features, many not always be understood until a crisis event, or until it's too late (for both the lender and the borrower).

In one period, debt may appear as a fixed-rate senior, secured liability. In a subsequent downturn, the same debt

might convert into a floating rate obligation with principal payments due that same quarter. While evaluating capital structure and debt-equity ratios, analysts should seek to understand debt nuances and understand the impact of a downturn.

1. Fixed rate, floating rate structures,
2. Senior secured, senior unsecured, subordinated, and convertible structures, and
3. Prepayment options, call options, financial covenants

A downturn will decrease earnings and cash flows. Yet it will also cause anxiety among lenders and debt-holders who all seek an advantage to ensure payback or a comfortable position going forward. Analysts must ask whether the company has a capital structure that can endure such scenarios and the posture-changes by lenders and other creditors.

#### Capital as Cushion: Surviving Stress

Besides providing a return to investors and helping to fund long-term assets, investments and expansion, capital provides a balance-sheet cushion. When a company confronts stress (arising from, for example, a recession, financial-market collapse, or customer defaults), ample amounts of capital help relieve companies from debt burdens, sudden losses, market wipeouts, or cash shortfalls.

Capital as cushion doesn't mean a company must manage a balance sheet supported all by capital and no debt. All capital implies the company is not exploiting the advantages of debt to generate improved returns on equity or to lower the overall cost of capital. (And investors will argue there is such a thing as too much equity capital.) The objective, of course, is to determine optimal levels of debt-equity—partly to avoid excess debt burdens and partly to ensure there is a sufficient capital cushion during downturns.

Analysts should, therefore, determine whether the capital structure is close to an optimal mix, one that also ensures a capital cushion exists for worst cases. To measure capital-cushion adequacy, analysts should perform some form of a balance-sheet stress test, using extreme-risk scenarios and measuring and deducing how the company will fare. The exercise is crude, but can tell

much about whether the company can endure these scenarios or is prepared for them.

Stressing the balance sheet is an attempt to quantify the maximum amount of loss all categories of the balance sheet will suffer within a defined period (one week, one month, six months, etc.). Losses might be due to collapse in asset values, business declines, surges in interest expense, volatile currencies, and customer defaults. After such losses (risks) are quantified (based on history, statistical probabilities, or worst-case assumptions), is there still enough capital (or better, liquid capital) to absorb losses and provide a cushion to keep the company afloat?

#### Cash flow: Is It Still King?

For the most part, balance sheets help companies ward off risks, but cash flow is still king, because earnings are why companies exist and cash flow permits payouts to debt-holders and investors.

Sustainable, high-probability cash flow is a goal that emanates from sustainable profitability. Analysts must ask themselves whether the company's operations can generate predictable, stable cash flows, even during downturns or when unanticipated risks arise.

Risk managers learned from past events that financial analysis must look for cash traps or stumbling blocks or any weaknesses or factors that might threaten cash-flow stability. In some cases, the company might report earnings, but cash generated from operations can't get to where it needs to be (to parent companies or other operating subsidiaries). That might result from:

1. Limited access to cash from unconsolidated or foreign subsidiaries,
2. Limited access to cash from regulated subsidiaries,
3. Cash sent from one affiliate to support activities or deficits in another,
4. Cash subject to unexpected tax treatments or other penalties, and
5. Cash necessary for unplanned capital expenditures.

Just as the balance sheet should be stressed and tested for worst-case scenarios, so should an analysis of cash

## REASSESSING AND UPDATING CREDIT ANALYSIS AND MODELS

flows, from the past and projected going forward: **How are cash flows affected by extreme risks?** The exercise should not be perfunctory. Analysts must sensitize cash flows from operations for many realistic scenarios:

1. No-growth business case,
2. Conservative, declining business case,
3. Unexpected escalation of certain costs (raw materials, interest rates, etc.), and
4. Unexpected payouts for emergencies, disasters, contingencies, or legal action

Sometimes there is a tendency to dismiss sensitivity analyses as unreal, unlikely cases. Recent crisis events show they can and do happen. Analysts, therefore, should determine the impact on cash flow in these cases or assess what the company is doing to minimize their impact on operations.

#### Off-Balance-Sheet Risks: Trouble Lurking Beneath

Analysts often forget to assess adequately off-balance-sheet risks, because the risks (a) are sometimes cryptically described in detailed footnotes, (b) are sometimes reported in an inconsistent way and at the discretion of the company, (c) are hard to measure, quantify or understand, or (d) have probabilities of occurring that are mere guesses.

In worst cases, however, many of those same risks all of a sudden appear on the balance sheet as real liabilities. Analysts should never shrug them off. Instead they should strive to understand what they are or request the company to explain them as thoroughly as possible.

Off-balance-sheet risks can range from financial risks to legal risks. They include pending legal action, unexpected environment costs, forward financial transactions, pension obligations, uncertain contractual commitments, or third-party guarantees. Recognizing the risks are real, analysts should:

1. Identify and prioritize the most significant of these risks, based on probability or immediacy of impact,
2. Request from companies more disclosures if the reporting is inadequate or difficult to interpret,

3. Determine how the same risks would appear on the balance sheet when the risks are realized,
4. Quantify as best as possible what the risks are or what the potential loss would be, and
5. Measure the impact of the same risks and potential losses on income statements, cash flows and balance sheets (capital cushion)

#### Borrowings: Getting Paid Back

For risk managers, analysis ultimately comes down to the company's ability to meet obligations: Pay interest or amortize debt; meet obligations arising from other bank-related activity (trading, funds transfer, securities processing, etc.).

Here is where the analyst starts to aggregate other parts of the analysis.

#### From lessons of the past, the analyst should ask:

1. Can the company fulfill obligations from primary sources: cash flow from operations, cash reserves, or other liquid assets?
2. Can the company avoid relying on secondary sources: sales of fixed assets, refinancing, new capital, etc.?
3. What are the significant threats and risks to both primary and secondary sources? How would they affect the paydown of debt in the short- and long-term? What is the company doing to avoid such scenarios?
4. Will new debt be necessary for the company to achieve planned growth? Will cash from primary sources be sufficient to manage the new debt? Or must it rely, too, on new sources?

#### Market-Based Indicators: How Meaningful?

In risk analysis, there is nothing wrong with using market-based models and indicators. They include, for example, a company's stock quotes or prices in credit-default swaps. They are reactive, up-to-the-minute measurements of a company's creditworthiness. They also include models based on bond-market prices and credit spreads and models based on translating a company's equity value into an assessment of its ability to meet debt payments.

At their best, they send warning signals or reminders that a company or

companies in an industry group require attention. They tap you on the shoulder to alert you that something might be wrong. And they suggest that more than a few people in the marketplace might have cause for some degree of concern.

At their worst, they garner too much attention, as herds of risk managers respond to the indicator instead of the company or the situation. And overwhelming response spawns panic or creates an avalanche of reactive behavior. In the summer, 2008, market participants and risk managers watched credit-default-swaps market activity and pricing trends for financial institutions hourly, observed signals of weakness, but couldn't necessarily pinpoint the triggers of weakness.

Market models and indicators are useful, if they:

1. Are understood and use variables, factors or influences that are readily measured and explained,
2. Are intended to be signals for possible decline and tools to suggest reasonable, courses of action might be necessary (updated company review, risk-rating review, exposure reviews, or discussions with the company), and
3. Are not substitutes for rational decision-making and in-depth analytical scrutiny

Post-crisis, for risk managers and financial analysts, a revised approach to credit models and financial analysis is to acknowledge extreme risks, worst cases, and prolonged downturns. They can and do occur, and companies and counterparties should show they are financially and operationally prepared.

Forward-looking financial analysts should take initiatives to update their approaches, techniques, ratios and models. More than ever, the models, like sleuths, should look for hidden risks, anticipate worst cases, and assess carefully whether those companies are prepared to withstand what most will say might not ever occur.

# THE CHANGING GLOBAL FINANCIAL MARKET

*There can be no doubt that the financial world – and perhaps the world in general – has reached one of those times when a continuation of the current situation is not viable.*

**This issue can be addressed from a number of positions. We know some of the problems including unrest in the Middle East, global indebtedness, increased activism and the global financial meltdown. Of course some of these are interlinked, but many of the solutions are also interlinked and therefore confusing. There are many things that are known. These include, for example the certainty that interest rates and inflation will rise, together with the likelihood that unemployment will remain stubbornly high for the foreseeable future. Governments will fall with increasing frequency – as I am writing this Portugal and Belgium are short of governments and many others are likely to also fall in the short term. So what does it all mean for you as a person, you as a company or you as a citizen?**

## **The Global Market**

We have written before that the current position whereby the submerging countries continue to use the resources and funds

of the emerging economies is clearly neither ethical nor sustainable. Increasing interest rates will continually bring this into sharper focus and will result in difficult decisions having to be made. You can achieve a balanced budget in a submerging economy – Norway and Switzerland have both achieved this successfully. It cannot just be about reducing the speed of growth of deficits; increasingly countries will need to significantly reduce their level of global indebtedness.

However this is easy to say but difficult to achieve. Civil unrest tends to follow the removal of an unfunded entitlement. Once some style of benefit has been provided many believe that it is their entitlement by right. That someone else has to effectively pay for it becomes part of the problem exacerbated by the fact that it is often people in emerging countries that are essentially the unintended victims.

We need to move towards a world where there is greater



## THE CHANGING GLOBAL FINANCIAL MARKET

balance and economic terrorism is significantly reduced. It is obvious that economic growth is required to achieve the balance that is required and this needs to originate from the private sector. Spending on government agencies by their nature is normally counterproductive. The consequence can often be that the subsidised government sector ends up preventing growth in the private sector through the operation of unfair competition. At worst the money is effectively wasted on schemes that add limited value whereas they should be investing in the future employment opportunities playing to the strengths of the relevant society.

We are perhaps standing on a precipice so now is not the time to take a brave step forward. This is why the fraud which essentially underpins quantitative easing cannot either be the solution or sustainable. We need fiscal tightening while stimulating the entrepreneurial environment encouraging growth and creating real jobs, rather than short term waste. Personal Aspiration

We do subscribe to the proposition that entrepreneurs are born not trained. You either are willing to take risk – or you are not. The conservative entrepreneur stays small making relatively minor iterative steps but fails to achieve their growth potential. Most people want their children to achieve more than they have achieved themselves. They seek to ensure that they have the resources to provide the start that is required and to create the aspiration leading to success. However there are others operating in a cycle of poverty without this style of role model providing limits to their potential achievement which may not actually exist. Both of these need to change. It is unlikely that the next generation in the submerging economies will enjoy an increasing standard of living. Without adding increasing global value you cannot expect to enjoy unearned benefits. With life expectancies increasing and more moral dilemmas to come the ability of intergenerational vales transference is likely to reduce.

To achieve growth in the global community you need to increase global flexibility and encourage aspiration in the emerging economies where this can add greatest value. This needs to take account of changing demands and market forces. We are living in uncertain times and with regret times are likely to become even more uncertain.

Aspiration and the ability to achieve will actually become harder to instil on a generation seeing the value of social media but limiting their interaction. Recently I saw a Group of late teenage girls in a restaurant – it was quiet since they were all texting, perhaps talking to their virtual friends at the expense of their real friends. The impact of social media can of course be significant and I am a major user of LinkedIn, for example. But this could have the unintended consequence of putting people into a bubble and effectively limiting their horizons. It is important to aim for the sky; else you will never leave the ground.

### The Financial Market

I am continually worried about the financial market. To be successful banks really do need to have real growth and certainty. That is not fraudulent quantitative “I want to bankrupt my children” growth. That is not “our children can

pay back 50% of our problems” growth. It is real growth recognising a changing business paradigm leading to sustainable employment.

I fully understand the demand for changing regulation although much of what is currently proposed is both illogical and mathematically naive. What is missing at present in the argument is the likely impact on people of the changes proposed in both the banking and insurance markets. If you asked someone whether they would rather be employed and adding value to society or unemployed in a market where no firm could fail I know which they would choose. Put at its most basic the regulators and governments are getting this wrong and the impact will not be what they are expecting.

The banking sector needs to be able to drive the growth in society providing cost effective certain services at an affordable price. A sequence of ill thought through capital changes which actually will have counterproductive responses will not solve the problem – rather they are the problem.

We expect new types of financial organisation to emerge which will not be banks. They will take measures risks outside of the mainstream of the existing financial markets operating in lower regulated environments and bizarrely increasing the risk in the whole system. The difficulty we have with the proposals currently going through is that rather than reducing the likelihood of failure they actually increase it. Financial entrepreneurs need to understand what is proposed and develop new styles of solution to encourage the demand which will surely exist.

### Global Changes

I do anticipate more changes to the post World War 2 status quo although it is hard to be sure where and how this will occur. What is certain is that it will be both painful and difficult. An expectation of a move to a fully democratic global market is at best a pipe dream. Regimes will fall and be replaced in some cases with regimes that appear even less democratic. New countries will emerge and merge. Europe will stumble onwards towards a future that is at best uncertain lacking economic logic or public support. Given the inherent bankruptcy of the current ridiculous European experiment significant change from within will be required. We would suggest closing Strasburg and the common agricultural policy together with probably two thirds of the anti-entrepreneurial legislation as just being the start.

If I were based in Germany I would have no doubt that German growth would increase were they to leave Europe. I also would expect this to be positive for the remainder of Europe as well. But with regret we doubt that this will actually happen.

So all we can look forward to is more politics, ineptness, regulation, bank strangulation, increasing interest rates and indebtedness and increasing unemployment. The rich will get poorer and so will the poor – but it does not have to be like this and one has to hope that we will not step forward from the precipice.

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# THE IMPACT OF GETTING REGULATION WRONG

*The regulatory environment for banking and financial services is in a process of major change. And the market is responding to the financial challenges of the last few years. Whether the changes would have in any way prevented the crisis is open to significant doubt – indeed it might even be considered that the parts of the industry that performed best during the crisis are now being penalised in the solutions being implemented.*

Regulation is generally developed in the wake of perceived problems that have occurred. It is not created in a vacuum, rather it is the actions of those seen as being responsible for regulation taken in the light of government or media pressure. Whether it is a secondary debt crisis, asset bubble or fraudulent activity each can have an impact on the regulatory structures that we face.

That it is often unaccountable bodies or groups that essentially develop such regulation is in itself a cause for concern. The global financial market is at the mercy of bodies such as the Bank for International Settlements and the International Accounting Standards Board which are unelected and unsupervised. Worse than that, they do not have the right set of objectives within their charters. If you look at the Bank for International Settlements in this area they focus on the development of best practice and capital rules which need to be implemented within local regulations to be effective. They are a committee of central bank governors although it is not the governors themselves that sit on the

committees, rather it is their staff.

If you are a regulator in a particular country and have a great person working for you, do you think you would send them to Basel to work on designing best practice? Might you instead send someone who is worthy and technical but perhaps lacks the practical skills required to regulate your local industry? It certainly might be considered as being plausible.

The next question is what role do we want regulation to take since that should lead to the structure which is most appropriate for the global market to develop. Since the financial market is intrinsically linked to the main economy surely there needs

to be regulation that delivers that which society requires. I would view society's aims as being:

- Economic growth
- Low unemployment
- Financial stability
- Financial crime reduction

Notice that I have neither included treating customers fairly or fiduciary responsibility. This is a deliberate decision since they can perhaps be better dealt with through other mechanisms, although these might certainly be considered as secondary objectives.

This leads to the obvious thought that the impact on the economy needs to be considered as the first magnitude in the development of any regulation. It would also suggest that the Grouping which should look to the development of global rules and



## THE IMPACT OF GETTING REGULATION WRONG

regulations should include parties with responsibility for the areas set out and would include the following:

- Bankers
- Regulators
- Businessmen
- The Public Interest
- Enforcement agencies
- Infrastructure agencies
- Supranational bodies

This might lead to quite a different grouping making rules to the current BIS committees which essentially consist of regulators. Unless the impact of regulation is considered in the light of the expectations for the global economy it can hardly be surprising to be found wanting.

### The Law of Unintended Consequences

We now have a wave of regulation washing across the financial community. Ranging from Basel 3 and Solvency 2 to central counterparties, collateral rules, operational and market risk rules, liquidity and credit rules it is hard to think of any part of the industry that is unlikely to be affected. But regulators should not wish for things that might actually happen. It appears that the intention of the regulators, following ill-informed media pressure is to develop a financial market where it is no longer plausible or acceptable for an institution to fail. The days of the central bank being the lender of last resort is essentially over since it is made clear that taxpayers will no longer be willing to pick up the tab for failure.

By developing a risk averse regulatory structure the regulators essentially are seeking to reduce risk taking. There are many types of risk taking within financial services which includes trading, lending and innovation. If the regulations are not correctly drafted innovation is stifled and risk taking, the lifeblood of the banking industry, suppressed. This results in a global financial crisis caused by a reduction in global GDP. The damage that poorly thought through regulation could cause must not be underestimated. In ensuring that institutions do not fail the reduction in global activity will ensure that governments and societies fail.

If you bias the rules towards the submerging countries of the G7 you impact the ability of the emerging countries to stimulate the growth that is required to service appalling government indebtedness. You also stifle the growth of small and medium sized companies which are the life blood of growth in times of stress. As we have indicated before this always leads to instability and unrest which can never be predicted and has itself negative impacts on the economy.

The ill thought through current set of regulatory change also has another impact. By suggesting a series of rules that will be implemented over a period in excess of 10 years you create a cost uncertainty which further constrains the ability of market participants to adequately price their products. If a firm cannot know for certain the capital requirements that will apply to a product over the life of the product, then they are forced into only offering short term products. This will also prevent companies from obtaining the long term financing that they require to stimulate growth.

If there is continual change there is also the risk that further mistakes will be made. Requiring firms to change the way they work globally and at the same time will also have a negative impact on the global economy – and will result in more problems. Which I suppose will result in more ill drafted regulation and even greater decline.

But the law of unintended consequences could actually come to the rescue. There are actually only a few things that are restricted to only being conducted by a bank. One of these is not lending and I certainly do expect lending to start to leave the banking industry. In trying to regulate the capital of the banking industry what the regulators may actually achieve is to move this risk from the banking industry to other market participants that operate under different or more benign regimes – for example venture capital and fund management businesses. Companies that have significant liquidity assets will be seeking return over the coming years and lending may well be one of the solutions identified.

Likewise forcing over the counter derivatives onto a central exchange does not mean that they will move there. Changing the regulatory structure enforces a change in behaviour leading to financial innovation. It is easy to design products which are not contracts for difference and achieve the same as the OTC derivatives that it is proposed move to the ETD markets. The cost of the transition based upon the necessity of designing margin requirements that ensure that the exchange will not fail will in most cases result in a lack of liquidity of the traded instruments which will then fail. New market participants will develop solutions which achieve the same as the current market. Again these will probably not be banks.

### The Future of Banking?

It appears that the regulators envisage a time when banks really become funds transmissions and deposit taking entities, with little else left. Everything else might well be more profitably conducted in business that is not a bank. By over or inappropriately regulating the industry you actually result in the transference of risk to other areas of business where it will operate without regulation. Basically increasing regulation of the banking industry could reduce regulation of the financial community.

Of course designing urgent rules to be implemented over in excess of a ten year period highlights that even the regulators do not really expect much of this to be implemented. Of course regulations designed to optimise the minimisation of regulators risk when interest rates are falling become both dangerous and poorly calibrated if interest rates start to rise – which they will. So everything will need to change and perhaps that may be the siren call to try to get a bit more common sense into regulation. But common sense is not very common and nowhere is this clearer than in the design of banking regulation.

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