



Risk Reward riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

Q1 - 2010



New Standards for Risk Management

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Dear Subscriber

Welcome to our first Global Risk Update of 2010. In this edition are eight original articles which deal with many of the current issues that are impacting the financial services risk management industry worldwide. Regulators are continuing to develop 'solutions', in the form of technical papers, to the latest industry problems, perhaps creating the next problems in so doing. In this issue two of these papers, together with the survey of risk areas recently commissioned are addressed. In December 2009 the Bank for International Settlements (BIS) published its proposals for strengthening capital standards. This large document will be covered in a number of articles this year as the rules are finalised – the first is included here and is our lead article. This is a seriously important discussion paper and it is critical for all banks to make their views heard at this time. Failure to do so will result in rules being adopted which do not take into account your views.

The 2010 Banana Skins report produced by the CSFI and sponsored by PwC throws up some interesting changes from previous reviews. Mary Phibbs has summarised these findings, highlighting the main challenges. There are a series of articles which are looking at the current problems facing the market and many of these relate to the impact of regulation on the global business community resulting in problems for banks. Simon Ling-Locke looks at problems building up in the banks, whilst Mike Skelton reviews the trade finance market.

Last week the BIS produced their latest missive on Corporate Governance and this includes the remuneration requirements. We have set out the principles that need to be followed and have provided some initial commentary reflectively. We intend to revisit this issue when the paper is finalised.

Other articles address problems within risk management. Mark Andrews has provided his third article on Islamic finance, whilst Tony Scrace has highlighted the project management problems of implementing Basel II in practice. Of course, as soon as Basel II is finished Basel III will be upon us, so continual change can be expected. Finally, Rohan Badenhorst has looked at the risk and reward conundrum, highlighting the challenges faced.

2010 will be another busy year for the risk management industry. We expect continued financial turbulence and regulatory change well into next year. Rules that will have been implemented in haste are likely to be repented at leisure, so risk managers will need to keep abreast of the key issues and deliver to their senior management what really matters. We look forward in this and future Global Risk Updates, to support you through these challenging times with the best international perspectives, guidance and best practise.

With best wishes



Dennis Cox BSc, FSI, FCA
Chief Executive Officer

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TO THE EDITOR

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RISK REWARD
MANAGE THE RISKS, REAP THE REWARDS

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NEW STANDARDS FOR RISK MANAGEMENT (PART I) – GOVERNANCE AND RISK CULTURE

Dennis Cox is the Chief Executive of Risk Reward Ltd, the Global Risk Forum and chairs the Chartered Institute of Securities and Investment Risk Forum based in London. In this first in a series of articles on this subject he proposes what he believes are the new standards for risk management in light of the plethora of recent reviews and papers generated by international regulators, national governments and the banks themselves.

Background

On 16 February 2010 the Committee of European Banking Supervisors (CEBS) issued their High Level Principles of Risk Management. This followed the declaration of the G-20 leaders on 15 November 2008 to “develop enhanced guidance to strengthen institutions’ risk management practices, in line with international best practices, and encourage financial firms to re-examine their internal controls and implement strengthened policies for sound risk management.”

As a result of conducting a gap analysis and developing a road map, the CEBS identified the following gaps that required addressing:

1. **Governance and risk culture**
2. **Risk appetite and risk tolerance**
3. **The role of the Chief Risk Officer and risk management functions**
4. **Risk models and integration of risk management areas; and**
5. **New product approval policy and process**

Of course only some of these were actually related to the crisis and as with any series of rules development the opportunity has been taken to look at a range of issues. In this series of articles we will look at some of the key elements of these new principles.

Governance and Risk Culture

The Risk Culture

The principles state that “A strong

institution-wide risk culture is one of the key elements for effective risk management. One of the prerequisites for creating this risk culture is the establishment of a comprehensive (covering all risk types, business lines and relevant risks) and independent risk management function under the direct responsibility of the Chief Risk Officer (CRO), or the senior management if a CRO is not appointed, following the principle of proportionality.”

So what actually is a risk culture and how can one be created? Can you just buy one from a consultancy firm? We often get asked to provide a standard version of a document that can be tailored to any bank – in this case no such document can really exist. A risk culture is driven from the tone of senior management and inculcates all of the employees and operations of the bank. It is all embracing and drives behaviour.

From our point of view it drives from the Goals and Missions of the firm and sets out the parameters within which risk management operates. The risk culture is higher level than individual risk elements and needs to be applied across the entire profile of the bank’s risk framework. Are there any risks where the risk culture is not relevant? I cannot think of any – any risk can be transformed, controlled, accepted or mitigated. Accordingly we view the risk relevant test as being relevant to the bank.

We would expect all banks to have

appointed someone as Chief Risk Officer even if that role were in some cases combined with other responsibilities. This will be addressed in more detail in a later article.

The Management Body

In paragraph 10 the paper states that “The management body is responsible for overseeing senior management and also for establishing sound business practices and strategic planning. It is therefore of the utmost importance that the management body in carrying out both its management and supervisory functions has collectively a full understanding of the nature of the business and its associated risks.”

This is particularly interesting and does represent a challenge for some risk management functions. Sound business practices are often under the responsibility of the business unit, with compliance responsibility sitting with some form of compliance officer. The paper appears to envisage the risk management function becoming involved in this area. We would expect this to be limited to ensuring that the right issues are taken into consideration by the compliance function, together with the maintenance of adequate evidence to support the decisions taken. Whether the risk management function could effectively veto what they consider to be an unacceptable business practice is rather a different issue.

Strategic risk management is always an interesting area. In many firms strategic risk does not fall within the

ambit of risk management. When implementing an enterprise risk management solution the inclusion of strategic risk into the risk framework is clearly important. The broader requirement on knowledge and understanding is a collective rather than an individual responsibility as currently drafted. That is an interesting approach and raises issues regarding whether there needs to be a balance of understanding between the executive officers and the non-executive officers.

To be able to demonstrate that these requirements had been fully met would require both a detailed report being provided to the Board, together with evidence of the discussions that take place being minuted. It is not in our opinion sufficient to just table the risk profile – there needs to be actual scrutiny and the engagement of both executive and non-executive officers is crucial.

Personal Responsibility

The following paragraph (Para 11) requires that "Every member of the organisation must be fully aware of his responsibilities relating to the identification and reporting of relevant risks..."

Within the Basel framework for banks opting for the advanced measurement approach with regard to operational risk, all staff members may have received training regarding

the identification of operational losses. Hopefully in many firms there will be complete risk registers dealing with all risks throughout the bank, although in many cases these exist within risk management and deal primarily with operational losses.

The requirements here go much further and appear to require risk training to take place throughout an organisation. From our experience such training tends to be limited to higher level operational and risk management employees and management. Clearly anyone in a business can incur or identify a risk and indeed it is people that actually do things that are most likely to result in additional risk being incurred. The development of training programmes, regularly reinforced by case studies examples and communication from above, that apply to all employees is therefore required. Many staff will understand little regarding risk and wonder why it applies to them – training will need to be innovative, practical and broadly based to meet these requirements.

It will be interesting to see how many firms actually choose to train all of their employees, which attempt to rely on documents being distributed and which train only senior staff hoping for a trickledown effect.

In future articles we will look at the other issues in this important (and mercifully short) paper.



THE BANANA SKINS REPORT 2010

Mary Phibbs, ACA, is a Chartered Accountant and banker with over 20 years experience in banking and finance in Australia, Asia Pacific and the UK. Her career has followed the development of the banking and finance industries in risk management, corporate and financial institutions, project and structured finance, capital markets, retail banking, wealth management, treasury and international business. In this article she reviews the highlights of this year's annual survey among banks worldwide known as the Banana Skins Report.

The Centre for the Study of Financial Innovation (CSFI) has recently published its annual "Banana Skins" Survey into the risks facing the banking industry globally. The report surveys a wide range of bankers, regulators and other interested parties and as the editors of the report point out is that what these parties collectively believe could well happen. As such it provides interesting insights into what risks are pre-occupying the minds of those who have and continue to be affected by the biggest financial markets crisis for a generation.

In our opinion it is no surprise that following the level of government intervention required to prop up the financial system globally the number one risk or "Banana Skin" is listed as "Political Interference". Many respondents were reportedly concerned about the political pressure that could be put on bailed out banks to "lend against their better judgement", the distortions that support had created in the market and how it would be gradually withdrawn. In all 30 risks are listed with the top 10 as follows (2008 ranking in brackets):

1. Political Interference (-)
2. Credit risk (2)
3. Too much regulation (8)
4. Macro-economic trends (5)
5. Liquidity (1)
6. Capital availability (-)
7. Derivatives (4)
8. Risk management quality (6)
9. Credit spreads (3)
10. Equities (7)

Whilst perhaps not surprisingly categories such as "Too much regulation" did not appear on the regulators list and "Corporate governance" was much lower for the "the bankers", overall the perceived risks are consistent across all the major banking regions and the different classes of respondent. This probably reflects both the globalisation of markets, the reach of the financial crisis and the overall pessimism reflected in the report about the world economy.

Macro economic trends feature high up in the overall rankings above as a result and the continued high position of credit risk. Concerns about asset quality, leverage and lagging losses are underpinned by fears of the possibility of a "double dip" back into recession globally and the impact that this would have on losses and bank balance sheets.

Credit risk is perceived as the greatest risk in the emerging

economies particularly due to a fear of asset bubbles following government stimulus packages. An unwillingness to undertake the write downs necessary was seen as a particular risk in many regions.

Against this backdrop when the report splits respondents into "Industrial countries" and "Emerging economies" different concerns and rankings are apparent. Comparing the two, the report lists the top five risks as follows:

Emerging economies	Industrial countries
1 Credit risk	Political interference
2 Credit spreads	Too much regulation
3 Macro economic trends	Liquidity
4 Currencies	Credit risk
5 Risk management quality	Macro economic trends

In the emerging economies the risk that spreads would not revert to a more accurate reflection of return for risk was perceived to be higher than for industrial countries. Currency concerns reflect the continued volatility in markets and question marks around the US dollar as a major reserve currency in many of these economies. Concerns around risk management appear to cover a wide spectrum from capability to process, culture and resources and the pressures that cost cutting to shore up banks profitability and capital could bring.

The report presents the survey data well and is careful to leave the conclusions to the reader. It is a thought provoking read and one which will no doubt be helpful to those involved with risk management in financial services in particular.

For a free download of the full report visit <http://www.pwc.com/gx/en/banking-capital-markets/banana-skins/banking-banana-skins-2009.jhtml>



ARE BANKS BUILDING UP A DEADLY PORTFOLIO OF UNDERPERFORMING LOANS?

In this article by banker Simon Ling-Locke, MBA, FCIB, DIPFS Director of Credit Risk Services at Risk Reward Ltd, the author explores the prospects of how we might be rushing towards yet another 'credit crash' in spite of efforts to avert this scenario.

What is Happening?

Over the last year or so many of you may have heard the phrase "extend and pretend" countless times. This is a situation where lender(s) agree to extend maturities and /or amend covenants on a debt instrument to a borrower to avoid an event of default occurring in the (vain?) hope that:

- the operating performance of the company will return to health, or
- the market will once again be prepared to refinance deals on high leverage multiples.

There is also a question of whether some banks are acting out of political expedience (and there is certainly anecdotal evidence of governmental willpower having an influence over hitherto commercial credit decisions).

The two issues we need to look at are firstly the potential size of distress in the European loan markets and secondly to consider whether "extending and pretending" will help companies and banks swim through the economic turmoil we are facing, or

whether the delay is storing up potentially larger and more insurmountable problems for the future.

How Big is the Problem?

For the period up until the first half of 2007 there had been a very significant cyclical upturn in US and European syndicated lending, with overall primary loan volume growth of over 2.5 times between 2003 and 2007. This growth was particular focused on M&A (merger and acquisition) and leverage financing, as can be seen in the two charts at the bottom of the page.

Under current conditions of limited supply or indeed the total exclusion from the credit market for some companies, then the ability for these more highly leveraged borrowers from the boom era to repay, refinance or re-profile their debt obligations must be strongly questioned. This is only part of the problem since more companies will also face deteriorating operating performances and real liquidity crunches.

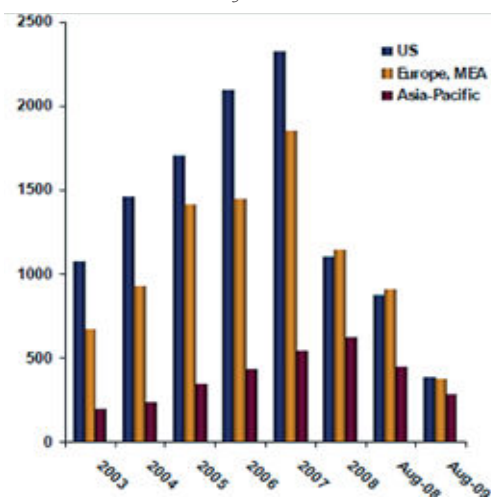
The Refinancing Cliff

As an illustration of the refinancing cliff the market is facing over the coming years the following chart is particularly interesting in terms of the sheer size of the refinancing requirement and the question of who will provide that funding. During the boom period up to the first half of 2007 over half of all European leveraged lending was funded by institutional investors, particularly through CLOs and much of this market has gone away due to forced liquidations for Market Value CLOs, liquidations or redemptions for Macro/Credit Hedge Funds, redemptions for TRS/Repo Financed Funds as well as for Unlevered Loan Funds which leaves Cashflow CLOs.¹

¹ **Collateralised Loan Obligation (CLO)** is a debt security collateralised by commercial loans. Usually a CLO refers to the entire structured transaction in which multiple classes of debt or equity securities are issued by a special purpose vehicle (SPV) whose assets consist principally of commercial loans.

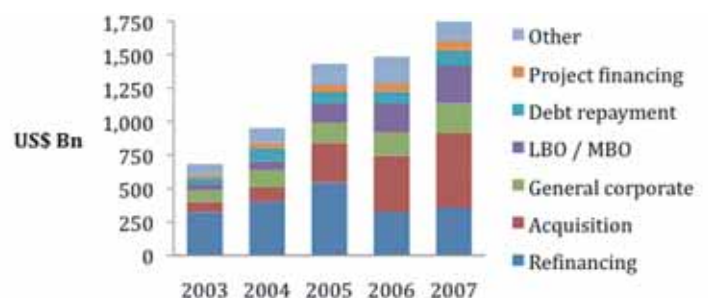
Primary Loan Volume (US\$Bn)

Source: Dealogic and Thomson Reuters



EMEA Loan Volume by Purpose

Source: Dealogic



Market-value CLOs have triggers written into them which force an unwind if the value of the loan portfolio (or the portfolio of swaps on those loans in the case of synthetic CLOs) falls below a certain level thus causing their liquidation.

Macro Funds use macroeconomic principles in leveraged CLOs to identify dislocations in asset prices, working on either directional or relative value plays.

Total Return Swap (TRS) is a bilateral financial transaction where the counterparties swap the total return of a single asset or basket of assets (for TRS Funds it is on a basket of CLOs) in exchange for periodic cash flows, typically a floating rate such as LIBOR +/- a basis point spread and payment against any capital losses. A TRS is similar to a plain vanilla swap except the deal is structured such that the total return (cash flows plus capital appreciation/depreciation) is exchanged, rather than just the cash flows.

Unlevered Loan Funds avoid leveraging up the CLO with debt and tend to be made up of long-only investors.

Cashflow CLOs are transactions in which the repayment of the CLO debt securities depend on the cash flow from the underlying loans.

Clearly, without a significant turnaround in market appetite for lending or of the emergence of trade buyers of leveraged companies over the next couple of years, a wall of distressed debt will quickly build up. This will impact market sentiment both in the primary and secondary markets across Europe and America and lead to further pain on the already stretched capital of banks as they mark down the values of these loan assets.

The Default Rate

If we now also look at potential default rates in the sub-investment grade market then the picture of potential distress becomes even more apparent, this during a time when many lenders have been willing to reset covenants to avoid defaults.

The Conclusion – Another Crash?

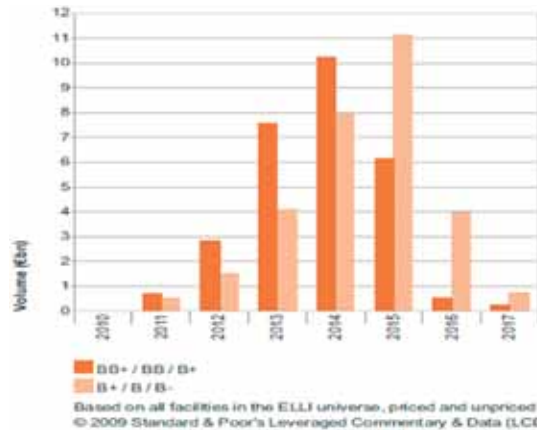
So, a picture of increasing levels of distressed debt in the market can be expected over the coming years. This conclusion is hardly rocket science, but then again nor was the prediction made by us that there would be a market crash by 2007. Clearly few wanted to

hear such an irksome message when profit targets were to be made (to paraphrase, hear no warnings, see no warnings, speak no warnings!). This is once again a time when players in the market need to sit up and prepare themselves for significant levels of restructuring and credit provisioning. You may ask why that is the case and in the next paper I will address this question by considering:

- impact from delaying a restructuring
- disconnect and lack of trust between management, owners and lenders (and indeed between

- different categories of lenders)
- the sheer volume of work and due diligence to be undertaken
- complexity and cross-border nature of many transactions.

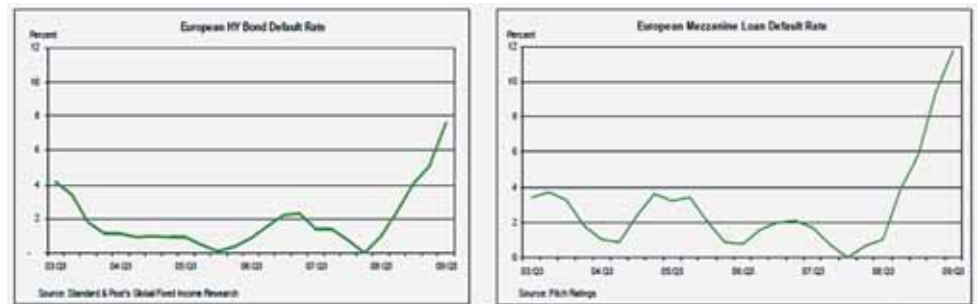
Look out for the following article in this series in the Q2 Risk Update.



Maturity Schedule of European Institutional Loans by Par Outstanding

European HY Bond and Mezzanine Loan Default Rates

Source: S&P and Fitch Ratings respectively



Moody's Global 12 month trailing speculative grade default rate since 1920 (%)

Source: Moody's and Bloomberg



MODERNISING THE INTERNAL AUDIT FUNCTION

Tariq Khan, B.Com, FCA, PIOR, is the newly appointed Head of Risk Based Internal Audit at Risk Reward Ltd. As head of internal audit at a leading international Japanese investment bank he set up a cutting edge risk based audit function and played a pivotal role in the establishing of the Audit Committee along Turnbull guidelines. In this first in a series of articles on the changing role and the impact of bank internal audit he describes the Basel Committee guidance to this changing and critical function within a regulated bank.



In 1998, when the Basel Committee issued its paper titled "Framework for Internal Control Systems in Banking Organisations" the role of the audit function was for the first time given formal recognition. Principle 11 states:

"There should be an effective and comprehensive internal audit of the internal control system carried out by operationally independent, appropriately trained and competent staff. The internal audit function, as part of the monitoring of the systems of internal control, should report directly to the board of directors, or its audit committee and to senior management."

It also emphasised, in principle 4 of the same paper, that internal control systems will be deemed ineffective if they do not consider and recognise material risks in their design. Thus, for the first time risk assessment was formally linked to sound systems of internal controls. Although some institutions were already practicing risk based auditing, it was not until this paper was issued that it got official recognition.

Recently, the Basel II Accord has reaffirmed these principles by stipulating that internal audit would have to capture in a larger way the application and effectiveness of risk management procedures and risk assessment methodology and critical evaluation of the adequacy and effectiveness of the internal control systems.

Basel II talks about risk based auditing in the context of management of operational and credit risk only, however, it has specific relevance to banks operating in emerging markets that are in the process of, or considering, implementing the accord. Whilst here in the UK we have had more than 10 years to practice risk based auditing, banks operating in emerging markets have now been forced to play catch up.

While the concept is straightforward, the application of a risk-based audit approach has taken many forms, from a once a year simple assessment of risk based on criteria defined by internal audit, or the board where these are available, to a much more complex model based approach where audit priorities and frequencies are reviewed and changed more frequently after considering the internal risk matrices of the bank. The choice depends upon the sophistication and risk maturity of the bank, capability of its audit team and the way in which the host regulators have translated these principles into their rule books.

Given the variety of risk-based forms available, for banks operating in the emerging markets, it is not a simple matter of just adopting a standard approach to risk-based audit as in practice there is no such thing. So what should a bank do when faced with modernising, or indeed establishing a new, audit function and what are the common traps that can endanger or derail its plans? It is perhaps best to discuss this question in the light of the UK experience. Why UK? Because perhaps the UK regulator has been the most advanced and successful regulator in the world in raising the profile and encouraging the firms under its supervision to take internal audit seriously.

Regulatory expectation

The interest in the audit function within the senior executive ranks has mostly been motivated by regulatory concern, which in itself is inextricably linked to external events such as a bank failure. In the UK, this interest began with the introduction of the new Banking Act of 1987. Section 39 (s39) of this Act gave the Bank of England (BoE), predecessor regulator to the Financial Services Authority (FSA), the powers to obtain an "Accountant's Report" on the whole or part of the operations of the bank. This power was used extensively by the BoE providing a bonanza for the "big 6" accountancy firms of the time. These Accountants' Reports tended to provide detailed analysis of the operations of the bank and in so doing uncovered many weaknesses in the control systems, which naturally led to recommendations for the establishment, or modernisation, of audit departments. It could be argued therefore that the credit for elevating the status of internal audit should really first go to the reporting accountants.

Since 1987 the role of internal audit has gradually gained more recognition in regulatory circles. But as mentioned above, it was the Basel paper in 1998 that propelled the audit function into the limelight. The successor supervisory body of the BoE, the FSA adopted these principles in its rulebook and under the heading of "Corporate Governance" set about transforming boardrooms and the audit function. Part of this emphasis on internal audit was related to costs. It was recognised, mostly from the experience of s39 reports, that supervision on the scale being envisaged would be very expensive. Their solution was allowing the banks,

as long as they behaved, a kind of limited "self regulation" in which internal audit and compliance functions were at the forefront.

The FSA now expects to be able to rely on the internal audit function as a "third line of defence" and in exchange it promises reduced supervisory enquiries and visits, which anyone who has gone through one of these knows very well can soak up immense management time and resources. So it is clearly in the interests of the FSA regulated firms to demonstrate that they have a strong robust internal audit function. Conversely, failures in internal audit will invariably lead to questions about its corporate governance which would in turn affect the credibility of the bank as a whole. It could also prove costly if the FSA demands a s166 report which is the successor to the s39 report mentioned previously. As a last resort, the FSA is also quite prepared to slap additional capital charges where they find that management have not taken serious steps to enhance and support the audit function.

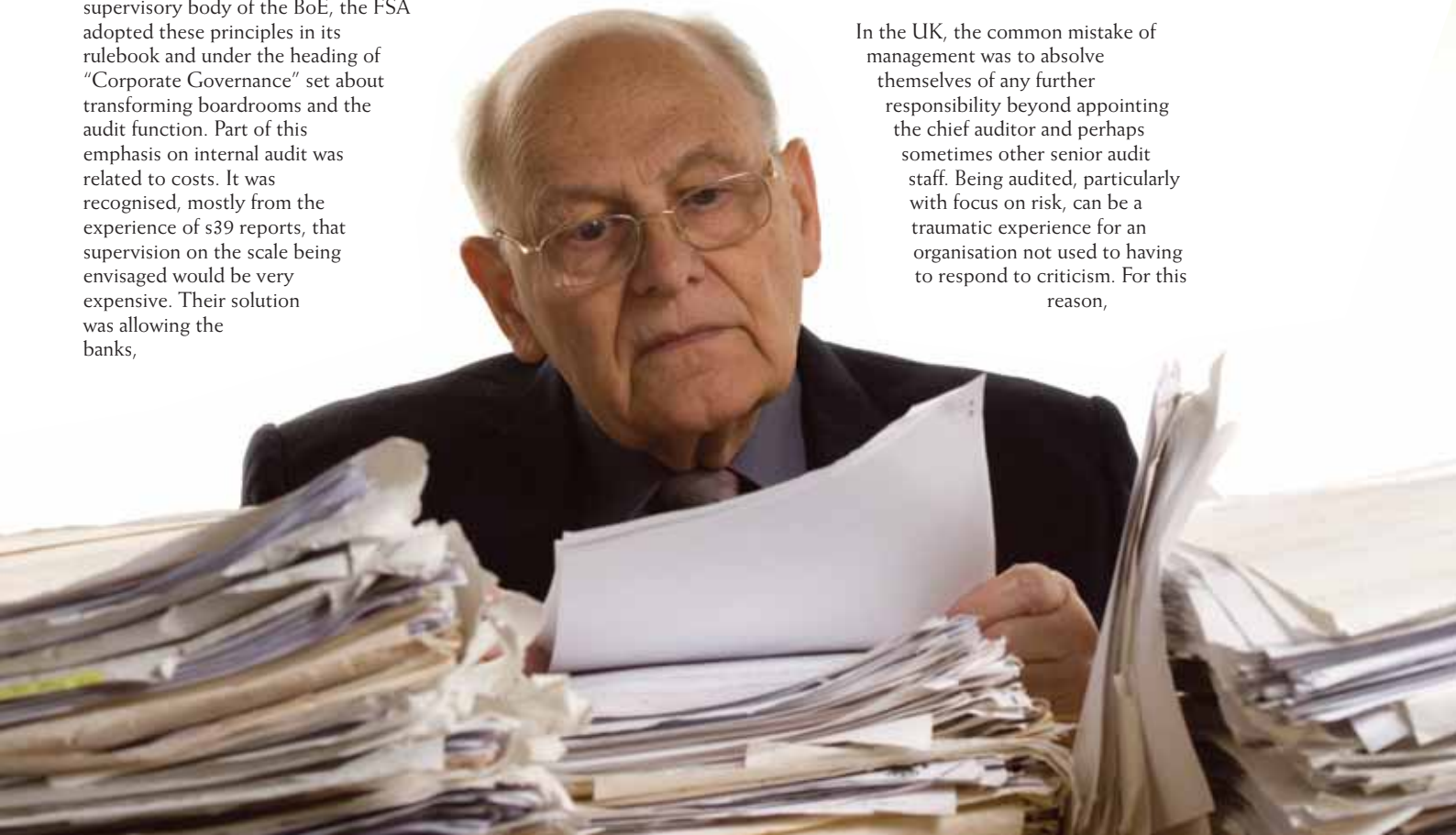
The establishment, or extent of modernisation, of an audit function in emerging markets will clearly depend upon the way in which the host

regulators will translate, or already have translated, the Basel principles into its rulebook. This in turn also depends upon the ambitions of the authorities in each jurisdiction to modernise its financial industry and its eagerness to gain international recognition as a centre of finance. The regime for penalties and punishments in each regulatory jurisdiction will also be a powerful factor for a bank in its approach to corporate governance and internal audit.

Supporting the audit function

Without any shadow of doubt, the success of the audit function depends upon the support executive management are willing to give to it. As demonstrated above, in the UK, senior executives interest in the audit function has mostly been motivated by regulatory concern. It is very rare to find an enlightened bank executive that fully understands the value of internal audit and of his own volition is prepared to invest, nurture and support it. But without this support internal audit cannot function properly. Frustration will set in quickly and most good people will simply head for the door. High turnover in an audit department is always an indication that something is amiss and it won't be long before the regulator will start asking questions.

In the UK, the common mistake of management was to absolve themselves of any further responsibility beyond appointing the chief auditor and perhaps sometimes other senior audit staff. Being audited, particularly with focus on risk, can be a traumatic experience for an organisation not used to having to respond to criticism. For this reason,



any effort to extend the audit function beyond its previous narrow remit is normally met with resistance from the line.

The involvement of the CEO in any modernisation programme is therefore a must if it is to succeed. Indeed, in the UK it is in his/her self-interest to ensure that it does. It is common to find that failings in corporate governance and internal audit have normally been blamed on senior management, especially the CEO, to whom the regulators invariably turn to for fixing the problems.

Support from the CEO, and his/her team, for the internal audit function has to be continuous and persistent. It is important to communicate regular statements of support for the audit function to senior and line managers. Meeting the head of audit and other members of the team on a regular basis to monitor their progress is important in ensuring that everyone in the organisation knows that the function is being fully supported at the top.

Audit Committees

The notion that internal audit should report to an audit committee is not new in the UK. Historically, the focus on Audit Committees came from the Combined Code on Corporate Governance, which has existed in various guises since 1992. Although many large commercial banks had functioning Audit Committees, their relationship with Internal Audit was superficial. It was not uncommon to find internal audit chiefs allocated only 15 minutes in audit committee meetings. In sharp contrast with their peers in other non-financial sectors, the banks executives did not pay much attention to the Combined Code until the new UK regulator, the FSA adopted the Basel paper in 1998.

Nowadays, it is widely recognised that no modernisation of internal audit can be complete without a properly functioning Audit Committee. Even foreign branches and subsidiaries operating within the UK tend to form some semblance of an audit committee.

In the UK, the FSA insist that not only an audit committee be formed but it must also comprise a majority of independent non-executive directors (NED's) and also that it be chaired by an independent NED, who should also meet with the chief auditor on a regular basis. The chair is also often required

by the regulators to meet each senior auditor separately to gauge his or her competence and report back to the Committee.

Ideally the Chief Auditor should report directly to the Chair of the Audit Committee. According to the newly appointed Chair of an Audit Committee for a major bank in the UK: "how else can I assure myself of the independence of the audit function?" The same Chair also insisted on being the budget holder for the function and had full responsibility for staffing matters.

In practice, however, the chief auditor tends to have a reporting line to the CEO for pay and rations and other staffing matters and a dotted line to the chair of the audit committee for matters of governance. Both the CEO and the chief auditor have to tread a careful line though as the effectiveness of the Audit Committee and its relationship with the internal audit function can often be compromised.

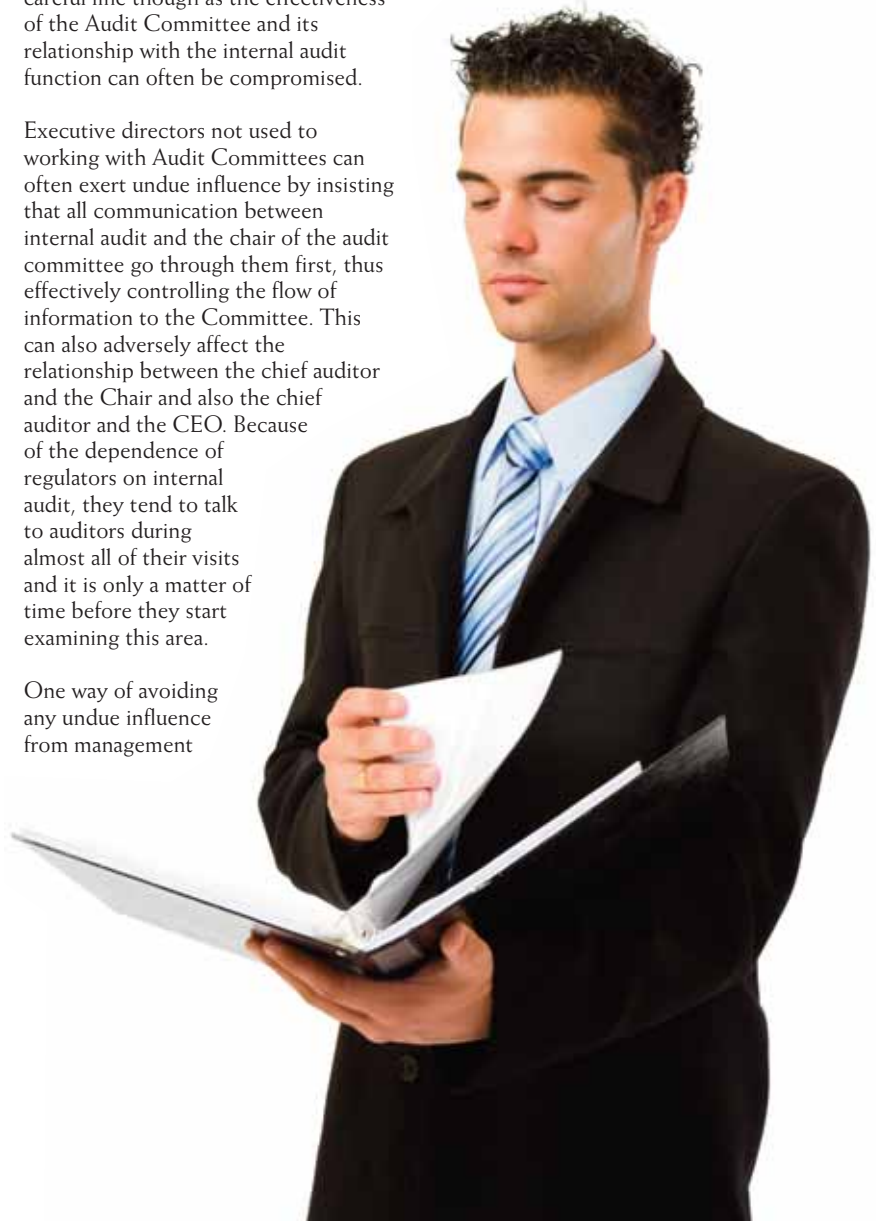
Executive directors not used to working with Audit Committees can often exert undue influence by insisting that all communication between internal audit and the chair of the audit committee go through them first, thus effectively controlling the flow of information to the Committee. This can also adversely affect the relationship between the chief auditor and the Chair and also the chief auditor and the CEO. Because of the dependence of regulators on internal audit, they tend to talk to auditors during almost all of their visits and it is only a matter of time before they start examining this area.

One way of avoiding any undue influence from management

on the relationship between internal audit and the audit committee is to state as a matter of policy that the chief auditor and the chair of the audit committee shall have unfettered access to each other at all times.

Appointment of senior audit personnel

Without doubt, the appointment of the chief auditor is a first and very significant step in the modernisation of the audit function. The chief auditor is the face of the internal audit function, he will make an immediate impression on how the whole function is perceived by others inside, and equally outside, the business. The chief executive needs to take a personal interest in the selection process. Whilst suitable qualifications and experience are always important, temperament and cultural fit are equally significant. You don't need



to end up with someone who will upset everyone in the organisation but equally you also don't want someone who is unable to hold his own in a confrontation and failing to protect the wider interests of the bank.

Managing the inspection department

In many larger banks in the UK, audit had sort of existed in the form of Inspections for decades before. Contrary to being regarded as a backwater, positions in inspection departments were highly sought after. Branch managers, and their able assistants who themselves were being fast tracked to management positions, saw a stint in the inspection department as a necessary prerequisite into more senior roles at the head office. Inspectors also tended to be typically long serving members of the staff, with informal networks and close personal relationships around the bank.

Creation of a new audit department resourced by outsiders on probably higher salaries than inspectors, inevitably caused friction. This was also a time of industry restructuring and upheavals brought about by deregulation, which made an already fractious situation volatile especially as the line positions that the inspectors were looking to walk into suddenly started to disappear.

The UK experience shows that the capacity of long serving members of the function to disrupt the modernisation process and allow it to settle properly and embed in the organisation should not be underestimated. Little things can irk their wrath with disastrous consequences. For example, at one bank some inspectors successfully persuaded the executive responsible for audit and inspection to have the newly created audit function "inspected". It transpired later that their main motivation behind this manoeuvre was anything but altruistic. Apparently, the inspectors were the same grades as audit managers. They felt very strongly that if they cannot have offices of their own, neither should the managers in audit. This personal agenda eventually led to a wholesale reorganisation of the

audit function. After that the relationship between the two functions never truly recovered. The resulting infighting eventually led to the replacement of the audit and inspection executive but by that time the damage had already been done.

Managing the disruptive elements of the inspection department, or an existing audit department, should be high on the agenda of the chief executive and should not be left to the head of the respective functions to sort it out between themselves.

Laying the boundaries

Modernising the internal audit function is likely to expand the scope of internal audit work into areas that until now have not been subjected to such an examination. To avoid confusion, it is important that there are clear boundaries within which internal audit is to operate. The setting of these boundaries is the responsibility of the board, or its audit committee, which it normally discharges by giving a mandate to the internal audit function, naturally in consultation with the chief auditor. In fact, good corporate governance necessitates that mandates are similarly awarded to risk, compliance and other governance functions as well.

To be effective the terms of reference should be clear and unambiguous. It is common these days, probably inspired by the new definition from the Institute of Internal Auditors (IIA), to see phrases such as assurance, consulting activity, add value, etc. creep into audit mandates. Phrases like these tend to obfuscate rather than provide a meaningful understanding in clear and unambiguous terms of what internal audit is all about and crucially what is expected of it¹.

However, it must be stressed that in internal audit matters, the regulators in the UK are influenced by the IIA and expect the internal audit function to at least provide some ad hoc consulting work which they often call consultancy or value added work. Besides undermining normal internal audit work by implying that it does not add value, these are also misleading terms.

Typically many internal audit functions reserves 20-25% for special work such as for fraud or other incident investigations, new system development projects and other advice on internal control matters that inevitably get sought by line from time to time. All of this work is perfectly legitimate for internal audit to get involved with as long it does not compromise its objectivity and independence. The only difference here is that this work tends to be ad hoc one off assignments specifically requested by management as opposed to the majority of the recurring work that is determined by a risk assessment process.

Management should also be careful not to succumb to demands from their line managers to get internal audit to do work which essentially is the responsibility of the line. The most common requests tend to be for drafting of policies and procedures. Asking them to review already written policies and procedures is of course a reasonable request and should be considered under internal audit's special work.

Finally, it must be recognised that the modernisation process can take some years before it can be properly established and embedded into the organisation. During this time a lot of changes can occur in the regulatory, economic and business environment, which will involve re-evaluating the governance framework and the structure of the internal audit function. Keeping apace with new developments not only keeps the regulators sweet but also ensures that the best talent is attracted to the function.

¹ I prefer a more traditional definition such as "To provide an independent opinion by an objective assessment and evaluation of the systems of internal controls, designed, installed and operated by management, and to report to management on their adequacy and effectiveness".

RISK BASED CORPORATE GOVERNANCE – THE NEW BIS PROPOSALS

Dennis Cox is the Chief Executive of Risk Reward Ltd, the Global Risk Forum and chairs the Chartered Institute of Securities and Investment Risk Forum based in London. In this article he briefly reviews the new Corporate Governance paper issues for comment by the Bank for International Settlements

The Bank for International Settlements have just issued a new paper entitled "Principles for enhancing corporate governance" for comment by 15 June 2010. These build on the Organisation for Economic Co-operation and Development (OECD) principles published in 2004 which were republished by the BIS in 2006.

The principles are as follows:

Principle 1

The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The Board is also responsible for providing oversight of senior management.

Principle 2

Board members should be and remain qualified, including through training, for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank.

Principle 3

The Board should define appropriate governance practices for its own work and have in place the means to ensure such practices are followed and periodically reviewed for improvement.

Principle 4

In a group structure, the board of the parent company has the overall responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities.

Principle 5

Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board.

Principle 6

Banks should have an independent risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board.

Principle 7

Risks should be identified and monitored on an ongoing firm-wide and individual entity basis, and the sophistication of the bank's risk management and internal control infrastructures should keep pace with any changes to the bank's risk profile (including its growth), and to the external risk landscape.



BANK FOR INTERNATIONAL SETTLEMENTS



Principle 8

Effective risk management requires robust internal communication within the bank about risk, both across the organisation and through reporting to the board and senior management.

Principle 9

The board and senior management should effectively utilise the work conducted by internal audit functions, external auditors and internal control functions.

Principle 10

The board should actively oversee the compensation system's design and operation, and should monitor and review the compensation system to ensure that it operates as intended.

Principle 11

An employee's compensation should be effectively aligned with prudent risk taking; compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment.

Principle 12

The board and senior management should know and understand the bank's operational structure and the risks it poses (i.e. "know-your-structure")

Principle 13

Where a bank operates through special-purpose or related structures or in jurisdictions that impede transparency or do not meet international banking standards, its board and senior management should understand the purpose, structure and unique risks of their operations. They should also seek to mitigate the risks identified (i.e. "understand-your-structure").

Principle 14

The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

What does this all mean?

We have 14 new principles which the BIS are proposing and these do collectively bring into the regulations the idea of risk based corporate governance. They are looking for subsidiary boards to take ownership of their risk profiles and do such actions as are necessary to meet these obligations.

The skills of Boards are now designed to operate individually and collectively, with risk management applied globally and at entity level. The underlying objective is to make sure that



the board understands its structure and that it is sufficiently transparent with its disclosure such that market participants also have the necessary appreciation of the risk profile.

And then of course there are the compensation requirements. By seeking to align the remuneration with prudent risk taking the regulators are seeking to reduce risk in the banking industry. Of course this will always be an objective – there can be no benefit to regulators in encouraging risk taking. What should have been required would be for the strategy and goals of the institution to be aligned to appropriate risk taking in a form acceptable to the regulatory authorities. Measuring the divergence from the goals and missions would be the key to the level of additional risk being undertaken as a result of the individual work being conducted.

It is in the assessment of the risk reward relationship, together with the introduction of risk mitigation, which would lead to a sensible conclusion. However the focus on prudent risk taking may lead to a reduction in the risk appetite within firms – and a deleveraging of the global economy.

This is another of those requirements which, whilst reasonable in theory is likely to have unforeseen consequences. A reduction in risk taking may lead to certain market dislocations and a reduction of liquidity. This in turn complicates the development of appropriate yield curves, resulting in greater uncertainty and a consequent increase in risk. The conundrum is that the rules would then continually enforce risk reduction to the stage at which it disappears altogether.

Are these a good set of rules or not? I do hope that they are read and the 40 pages considered appropriately. From our point of view the general governance principles or risk based corporate governance are broadly welcomed. However the compensation parts of the paper are a greater concern and, hopefully, will eventually be tempered in their enthusiasm.

TRADE FINANCE - LOWER THE RISK AND INCREASE THE REWARD!

Mike Skelton is a banker with over thirty years knowledge and experience in trade finance and international trade related practices and procedures which he has gained by working in the trade operations, sales and training divisions of Midland HSBC, NatWest, Royal Bank of Scotland and Barclays. In this article he explains the fundamentals and essential value of trade finance at a time when many banks and financial institutions worldwide are more active than ever in this field of activity.



Trade finance has stood the test of time - it has been around for thousands of years, with historians tracing the concept back to the Ancient Roman Empire where factoring and invoice discounting was used by money lenders as a means of financing trade transactions between local merchants, traders and warehouse owners.

In the 1800s trade finance really came of age as a result of the growth and development of trade and relations between countries in Europe, in particular China and India. On the back of this steady increase in cross-border trading activity a number of European banks made a strategic decision to capitalize on what they believed to be a remunerative and sustainable income generation opportunity. They did this by opening branches in China and India with the objective of supporting the buying and selling of commodities including silk, cotton, rice and tobacco (even opium!) using trade finance techniques and mechanisms that are still used today by banks worldwide.

These days, the use of trade finance practices and procedures is by no means restricted to trade flows between two particular geographical areas of the world. Indeed, banks and financial institutions globally use trade finance as a tried and

tested **low risk** and **highly remunerative** alternative to conventional working capital facilities.

As the financial sector begins to move slowly out of the global recession it is very clear that banks and financial institutions around the world are revisiting and revising their lending strategy and criteria for both existing and potential new customers.

The whole of the global banking and finance sector has recently been deluged with bad publicity about sub-prime lending and associated toxic debt, the collapse and bailout of a number of high street institutions, global financial meltdown, the credit crunch and subsequent negative/restrictive trading impact on hundreds of trading businesses around the world.

All these factors, coupled with reduced levels of liquidity and confidence in the inter-bank markets, have resulted in money becoming a scarce resource with banks and financial institutions seriously scrutinizing their risk/reward return on individual lending propositions more than ever.

This renewed caution within the global financial sector, partly due to the factors mentioned above, has resulted in fewer credit applications and proposals for both existing facility renewals and new money being presented by banks/financial institutions for sanction, and ultimately a decline in the number of actual requests being agreed and signed-off by credit committees.

Using trade finance techniques instead of traditional working capital finance facilities e.g. 'pot' finance or overdraft, greatly enhances a bank/financial institution's risk/reward profile by providing additional comfort gained through transactional control, along with additional fees and commissions earned by adopting integrated financing solutions using classical trade finance products, such as documentary credits and collections.

Unlike with traditional working capital solutions, in a typical trade finance deal it is possible to break trade related business

into its constituent parts and thereby gain a better view of potential areas of risk. Structured loans can be used in place of 'pot' finance or overdrafts which, whilst offering the customer maximum flexibility, are also open-ended from a risk perspective e.g. they can be used to finance the purchase of items not related to the core trading business of the customer. Trade finance structured loans typically have specific limits and maturity dates set to coincide with the customer's cash flow generated by the sale of goods.

The reality is that trade finance structures offer banks/financial institutions considerable advantages over and above traditional working capital facilities:

- Using trade finance instruments (e.g. bills of exchange, promissory notes, documentary collections and documentary credits) in conjunction with structured loans enables a bank/financial institution to exercise transactional control and fully maximise risk mitigation opportunities throughout the customer's trade cycle.
- Trade finance facilities are closely matched to the customer's actual funding requirements and trade cycle in line with each individual trade transaction.
- Unlike conventional 'pot' finance/overdraft, the funds advanced to the customer are provided for a specific purpose and cannot be easily diverted into supporting general working capital or indeed financing losses.
- Repayment of facilities is directly linked to the sale of underlying goods on an individual invoice by invoice basis. Any delay in repayment of a structured loan at maturity provides the bank/financial institution with an early warning of potential customer liquidity problems.
- Structured facilities increase the quality and quantity of account information for banks/financial institutions which improves overall credit quality through an enhanced ability to monitor risk.
- In certain circumstances the bank/financial institution might have a prior security interest in the goods financed using a trade finance structure, enabling them to easily identify, take possession of and sell the underlying goods if necessary to repay the loan/facilities.
- The increased levels of comfort which banks/financial institutions can acquire through trade finance techniques coupled with the ability

to 'make more money', should arguably have a more positive effect on the willingness to make credit facilities available to customers involved in international trade versus the provision of traditional 'pot' finance or overdraft facilities.

In conclusion, it is fair to say that even during times of global economic recession and financial meltdown, trade finance remains the solution that can offer banks/financial institutions both a **lower risk** and **higher reward** lending proposition.



ISLAMIC FINANCE – AN INTRODUCTION – PART III

Mark Andrews ACISI IFQ, is Risk Reward's Director of Islamic Banking and Finance. He has been an investment and retail banker for over 25 years and a qualified specialist in Islamic banking and finance. Since 2007 Mark has worked in most countries in the Gulf and Egypt advising on Islamic banking products and risk. In this third article in a series he considers how an Islamic Bank "advances" its funds, or in old fashioned banking terms, how it "makes its money".

INVESTMENTS

Whilst the terms "loan" or "lending" are commonly used, even by Islamic banks, they are not strictly correct in an Islamic context because an Islamic bank is engaged in mutual trading both with and alongside its clients on both sides of the balance sheet. An Islamic bank has a direct interest in the outcome of all these trading transactions, sharing both profits and losses with its partners/clients. Unlike a conventional bank where depositors are creditors and borrowers are debtors and there is almost no mutuality at all, an Islamic bank has partners, investors, principals and agents at every level.

So an Islamic bank does not "lend", it "invests"!

So how does an Islamic "invest" its funds? The answer is "very carefully" and for this reason only a handful of the Islamic products available are actually used in practice. This has caused Islamic banks – on the investment side at least – to become rather narrow specialists, dealing mainly in two products; split between Murabaha (akin to a loan) and Ijara

(akin to leasing operations). Most Islamic banks will advertise a wide range of Islamic investment products, including mortgage funding but most – in fact nearly all - have the lion's share of their investments in either Ijara or Murabaha form.

Why is that?

THE COMMON QUESTIONS

Before answering the question and as a preliminary explanation, let us consider Islamic banking from the customer's viewpoint, as an investor (in our language, depositor) in an Islamic bank. During the author's informal discussions with Islamic banking staff, especially those dealing regularly with clients, three questions emerge that are nearly always asked by every prospective investor (depositor) in the bank.

The first is "**Promise me this is an Islamic Bank?**" This is a particularly common question when a "windows" or "branches" approach is being used by the bank but is also asked of wholly Islamic institutions. Some Islamic banks have



questioned the wisdom of operating “windows” as a result of this constant scrutiny and to be frank, there is something “other worldly” about entering a conventional bank and following signs for “Islamic banking, this way!”

The second question is “**Is my money safe?**” which is interesting, given that for those of us banking with conventional banks, the prospect of an Islamic bank failing would mean we are probably all doomed! In nearly every Islamic jurisdiction either the State or the Regulator has made it clear that investors will not be allowed to lose their money and whilst nothing is impossible, it is hard to imagine an Islamic bank in the GCC in particular, being allowed to fail. The prospect of investors “sharing or bearing losses” as they agreed when they signed up (most don’t realise this by the way!), seems as remote as it can ever be.

The last question is “**Am I getting the best return?**” to which the answer is invariably “yes, of course”, because the answer “no, the bank down the road is more competitive than us!” might be career limiting!

Once these three common questions are satisfied, most clients, I am told, are then happy to take nearly everything else on trust. Is this any different from a conventional bank? Probably not in the case of the last two questions and it means that just like any financial institution, an Islamic bank’s cost of funds has to be set at a high enough level to attract new and retain existing investments. This obviously means that on the other side of the balance sheet the bank must make investments (loans) at a higher level of projected return than it pays for its source funds (deposits), to make a profit. So far, so good. But what is the easiest way in risk/reward terms to achieve this? Well, by using the simplest and most remunerative products which just so happen to be Murabaha and Ijara!

MURABAHA – AN ANCIENT CONTRACT

Murabaha and Ijara are two of six ancient trading contracts, which predate Islam itself and are reckoned to be thousands of years old. Both have underpinned trading in the Middle and Far East for millennia and were adopted by the Prophet (PBUH) because they worked so well and still do.

Because Muslims may not charge interest but can make a profit, the basic trade deal, the Murabaha, is a “cost plus” transaction in which the seller supplies goods to the buyer at a price which includes his disclosed costs plus a disclosed profit. When accepting the goods, the buyer agrees to the selling price and is aware of how much profit is being made (the argument being he can choose not to buy if he dislikes the price). If the buyer requires time to pay, then this can be granted, usually in return for a higher price including a bigger profit. This is one of the ways that the time value of money can be covered under Islam without charging interest.

Before the reader cries “fiddle”, let us consider some of the Islamic rules surrounding Murabaha transactions which are designed to encourage fair trade. First the seller must own and possess the goods which must be under his control. The goods must have a fungible value and there must be no uncertainty about quantity, quality or delivery dates. The seller may not take advantage of the buyer, may not cheat, deliberately mislead, overcharge or be anything other than scrupulously honest with him or her. Delivery and transfer of ownership must take place when the transaction is concluded. Once the deal has been done, it cannot be amended without the express approval of both sides. There is also the usual

prohibition on trade in haram items (alcohol, guns, pork products etc.)

These ancient Murabaha trading rules are clearly framed to avoid disputes or problems and no doubt evolved over time. They were adopted by the Prophet (PBUH) because they worked so well. In fact a deal in which the seller has to be scrupulously honest and reveal both his cost price and his profit margin is remarkably refreshing to Western eyes where usually neither is disclosed.

INTERNATIONAL DIFFERENCES

Provided the rules set out above are followed, a Murabaha can be for almost any amount and in theory any time period although the range is usually 6 months to 10 years depending on the bank which will also set minimum and maximum loan amounts.

So Islamic Banks provide Murabaha facilities for clients who want to purchase almost any item that qualifies. But there are some complications as a result of differing interpretations between Scholars which make the process slightly different even between banks based even in the same country. Take an example of a client wanting to purchase a car for US\$ 30,000 and being offered 100% funding on a Murabaha over a 4 year period.

For the transaction to be Islamic, the Islamic bank must be the owner and supplier of the car which means it must purchase and take delivery from the supplier before selling to its client. This creates a delivery risk as the client could walk away before the transaction is complete. Some banks insist on a promise to complete from their client, others go further and ask for a non refundable deposit (Arbun). Some Islamic Scholars are happy with either a promise or an Arbun or both, others are not saying it is not Islamic. (Luckily and at the risk of spoiling the story 99.99% of clients applying for funding do not walk away once the deal has been agreed!)

The second point of difference is delivery. Some Scholars insist the Islamic bank takes physical possession and in our example must store the vehicle in a warehouse prior to delivery. Others are happy for ownership to pass on paper, in other words there is constructive delivery only.

RETURNS ON MURABAHA – USUALLY HIGH

Despite these differences, Murabaha s are priced at the higher end of the consumer funding scale and use as benchmarks the appropriate EIBOR, SIBOR or other medium/long term rate measurement. The risk/reward profile is at the better end of the scale for the bank, the transactions are simple (albeit document hungry), easy to establish, can be used for almost any purpose, are simple to manage and normally well secured. So from the Bank’s viewpoint this is relatively easy high coupon lending.

The only serious drawback is that the banks reward (profit margin) must be fixed at the outset, when the Murabaha is agreed and delivery concluded, so the returns have to be set high enough to absorb rate movements against the bank. Either that or the portfolio must be turned over regularly so that the impact is diluted.

NEXT ISSUE – PART 4

In the next article we will consider Commodity Murabaha – a controversial product in some areas, but not in others and Ijara.

PROJECT MANAGEMENT ISSUES SPECIFIC TO IMPLEMENTING BASEL II

In this article Tony Scrace, FCA Chartered Accountant, risk manager and banker for over 25 years, draws upon his experience as Project Manager for Lloyds TSB International Banking Basel project and his support role of the Lloyds TSB Group Project in relation to Data Accuracy when offering advice to those who might be embarking on similar missions in their banks.

The Basel II implementation project presents all the usual project management problems that a bank normally faces, together with as a few of its own. This article details some of the issues that Basel project managers are likely to come across in the course of their work.

Different Regulatory requirements

Basel II is being implemented across the globe and even though the underlying principles set out in the BIS documentation are being followed, Basel II is being implemented at different speeds and in different ways in different countries. The rules themselves are continually evolving and different regulators take different approaches to the same issue. This can make life difficult for a subsidiary of a multinational financial institution which needs to meet the regulatory requirements of the head office's regulator, the local regulator and is probably using a third system to decide the risk parameters for commercial decision making. If at all possible it is worth looking at designing a system which at least collects the information needed for all the actual and potential users of the risk data in a single process. A little foresight can result in significant future savings.

Competing priorities

Implementation in each country starts with the local implementation of the BIS documentation which is then developed into legislation. This legislation is then implemented under the guidance of the local regulator. Within each country the individual banks may have some leeway as to how they implement Basel II, but this can vary considerably from some regulators taking a strict adherence to detail approach whereas others are more concerned about principle. Each of these stakeholders has different priorities and focus. The regulators are most concerned with avoiding damaging bank failures that might result in the failure of another financial institution. They may also be seen as being in competition with other regulators and can also be influenced by national pride. On the other hand, bank senior management may be looking to increase profits or to maintain their perceived competitive position. These competing priorities make it difficult for the Basel II implementation team to make choices which will keep everyone happy. Therefore it is important to sort out early in the project life cycle what the regulator really wants, how the bank is going to meet that requirement and use that data to manage the business effectively.



When Basel requirements are implemented much of it will be new and few people, including the regulator, will be quite certain what is acceptable in terms of systems, documentation, data accuracy or what certain aspects of the legislation actually mean. The consequences of this include the fact that many systems have been built by banks which have subsequently been found to be unfit for purpose and considerable costs have been incurred doing the work all over again. The need to keep step with regulatory demands has necessitated extensive discussion

between banks and regulators about what is required. Try to keep your regulator informed and point out when you see that the decisions they have made are resulting in unintended consequences.

It is massive

The documentation is voluminous with thousands of pages of text issued by BIS, supplemented by many new additional papers. This is supplemented by papers from the Committee of European Banking Supervisors, local regulators and other bodies. It is easy to get lost in the detail and trying to keep track of evolving regulatory guidance can be a thankless task. The UK regulator has developed a good structured approach with extensive glossaries which help a lot, but these can also confuse. The interaction of all these rules can have surprising and unforeseen consequences. Individuals implementing these rules can easily stumble down blind alleys or misunderstand the regulations. It is always worth getting someone independent to check the interpretation that your firm is placing on a regulation. Calculation errors in work conducted can easily lead to Capital Requirement calculations being materially inaccurate.

Data

Data is one of the big issues of Basel II because raw data, mainly customer data, is at the heart of the calculation of the capital requirement. Under Basel I the data required for the calculations was mainly summarised financial data, now vast amounts of detailed customer data is needed to calculate the factors. The two big issues are data availability and data accuracy. For many of the Basel models, data is required which goes back five or more years - but banks have not collected the required data over the required time period so the data is just not available. This makes building and proving your model much harder. Data accuracy is an issue because if you are going to use this data to calculate the capital requirement the calculation is only going to be accurate if the source data is accurate and ensuring this is much more difficult than people realise.

Consistency across the business

The number of decisions which will need to be made by all levels of the implementation will be enormous and it is essential that responsibility for decision making is clear. Good central support and advice can help by



allowing for the sharing of best practice so that decisions can be made consistently across the organisation. So you need the continued support of senior management to get a successful implementation.

One for the Accountants

Reconciling the Basel II numbers including capital required, risk weighted assets and capital charge on a management basis, a statutory basis and preparing the solo consolidations are always time consuming activities. Make sure when you are designing the system that you have collected the data which will allow you to complete these exercises.

Change and Stress Testing

Regardless of the project that you are running there will be need for continual change. Such change may arise due to the changing obligations posed by regulators both locally and internationally. Further the expectations of management and the regulators will also be changing placing additional demands. The increased focus on the softer data areas of risk appetite, stress testing and scenario modelling all place challenges which need to be faced. It is these areas where action can save the financial institution under times of real stress.

However it is important to make sure that the management understand what stress testing and scenario analysis can achieve – and what it cannot. They need to take ownership of risk appetite and understand that it is a business driver, leading to improvement of the business. At the heart of the issue is that a failure to get sufficient management buy-in will lead to a failure of the project and could indeed be a career limiting event.

Last Thoughts – Smoothing the way

Wherever you have got to in the process of implementing Basel II it is well worth getting an independent audit / review of the operating model, calculations, documentation and functionality.

A review could easily save you millions by helping to avoid various issues including:

1. Project rework or delay because
 - a. the final system is unfit for purpose
 - b. essential data items have not been collected by the system
 - c. the underlying data is not accurate
 - d. the legislation has been misunderstood
 - e. sub optimal options have been select, e.g. risk weighted calculation options
 - f. failure to convince the regulator that the total operating model including management control is sufficient
2. Wasting resources on unnecessary project work
 - a. building an expensive system to reduce risk weighted assets using collateral when the collateral is of insufficient quality to be recognised by Basel II
 - b. not using cheaper options for smaller portfolios
3. Incurring penalties (including fines, requirement to hold more capital, etc.) for not meeting regulatory requirements and deadlines.
4. Delay in taking advantage of possible capital savings.
5. Damage to reputation or competitive position if other banks are more advanced

THE INTERSECTION – WHERE RISK, VALUE AND REWARD LINK

Rohan Badenhorst is a CIMA qualified Chartered Management Accountant with a speciality in tax. He advises and trains the financial services and major corporations in both developed and emerging markets (Saudi Arabia, South Africa) on a wide variety of topics including International Financial Reporting Standards (IFRS).

Introduction

Risk and Risk Management in general can be viewed from two perspectives: A negative and a positive risk management view.

By negative risk management we mean the following: The risk management approach in an organisation that is designed to prevent the downside consequences of a transaction, such as (1) mitigating a potential loss or (2) the cost of not complying with regulatory requirements, as two examples.

In a positive risk management framework, the upside is managed in conjunction with a risk based approach to general management. This is the starting point of Enterprise Risk Management, but we extend the argument and management philosophy even further.

The approach:

We have created our unique principles directed Risk Oriented Value Management framework consultancy solution. The overall philosophy and practical application of the model is embodied in a sound risk management framework underpinned by the convergence of Internal Auditing and Financial Controls and the Value drivers inherent in the Value Based Management approach, namely

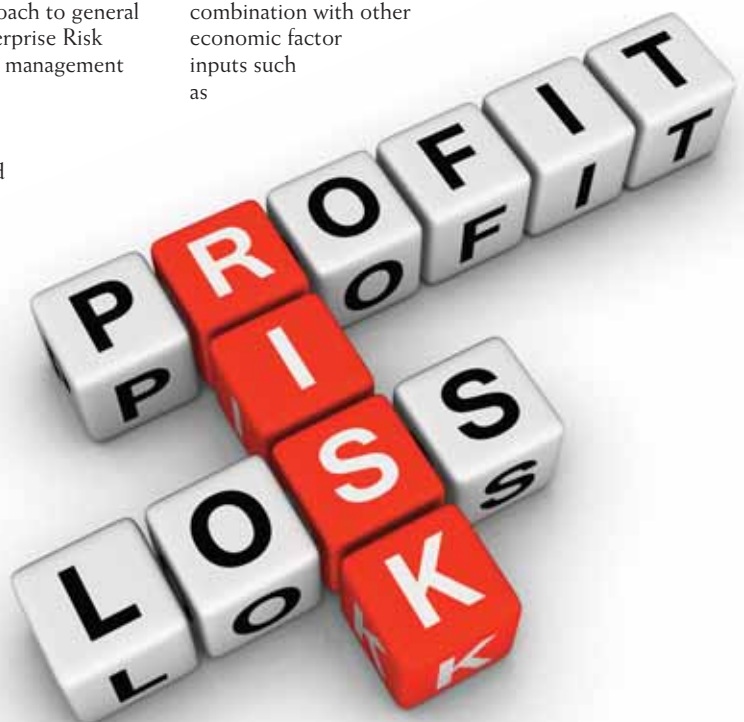
- 1 **Creating Value**
- 2 **Managing Value**
- 3 **Measuring the Value created**

The focus in measuring and managing for value and thus superior organisational performance is encapsulated in performance and investment drivers such as:

- a. **Sales Growth**
- b. **Operating Margin**
- c. **Cash Tax rates**
- d. **Fixed Capital Investment**
- e. **Working Capital Investment**
- f. **Cost of Capital**
- g. **The Planning Period**

Creating Value

The departure point in creating value ultimately has to have Innovation as one of the factor inputs required to create Economic Value in any organisation. This in combination with other economic factor inputs such as



capital, land and labour are the foundation building blocks of any organisational sustainable growth approach.

Therefore, combining resource inputs such as capital and labour with innovation, in the right mix and during the right time frame are the sustained growth drivers in any organisation.

Managing the Value

In a Risk Oriented Value Management approach risk managers assist their clients in filtering the noise and distractions along the way as it exclusively focuses on the underlying Value Drivers:

Sale Growth Rate

As the starting point profit and growth planning must set a solid platform to help drive the organisation forward. Whether the approach is to focus on product or market development, or a combination of both, risk managers help identify the resource allocation pressure and decision points, in order to maximise the return on effort invested.

As a top line focus point Sales Growth helps galvanise the organisational management and employees to identify suitable market opportunities to pursue to overall sales or set-off objectives.

Operating Margin

Operating margin becomes the focal point for operational efficiency and cost management strategies. During the recession most organisations have looked long and hard at this particular area, partly because sales growth has suffered quite severely, but also because they have realised that in any growth cycle such as we experienced between 2003 – 2007, 'organisational operational padding' have added unwarranted inefficiencies to their operating processes.

The conundrum at the moment facing most organisations is the question of how to drive sales forward and upward, with the reduced operational cost base in place. The two major levers of Sales Growth and Operational Cost need to be manipulated with the utmost delicacy and 'a very steady hand on the tiller'.

Cash Tax Rates

It is a given that the focus of most western governments will be on maximising Treasury tax takes over the next few years, in order to manage the huge fiscal stimulus packages introduced to support the economies. We expect quite a militant and aggressive approach in this area and a deluge of mitigation and profit extraction strategies to drive this 'opportunity cost' of business (your licence to operate fee) down. This is an area best left to the specialist in the area, however, it is still a value investment of your time to keep a beady eye on this 'hidden value driver'.

Fixed Capital Investment

Financing and timing are the two major factors to consider in Fixed Capital Investment area of your business. A creative off balance financing strategy might assist in extracting value in this area; however, the key issue is to have the capital infrastructure in place to support your organisational objectives. Taking advantage of distressed assets values might set up and gear the organisation towards supporting the initial Sales Growth driver.

Working Capital Investment

Liquidity and liquidity risk management are the key focus areas in maximising value in your working capital management processes.

Cost of Capital

A one-off opportunity to positively manage the organisational cost of capital down has emerged at the end of this recessionary cycle; however, it is up to the astute organisational leadership to take advantage of the opportunity. We recognise that a multitude of factors currently exist which might make taking advantage of this unique opportunity quite challenging, however, if the platform and measurement dashboards, combined with the organisational structure and resources are in place to take advantage of the historically low cost of capital rates, we encourage every organisation to take advantage of this potential opportunity.

Planning horizon

Clearly understanding that a longer term timeframe is genuinely beneficial, combined with regulatory factors encouraging the long view at the moment, will help the organisational leadership grasp both drivers of value in this factor, namely the current departure point and value calculation and the ultimate exist strategy value or Terminal Value of the organisation.

Measuring the Value

Risk managers should develop a unique dashboard and measurement instruments to help diagnose and drive the management effort towards the Value Based Management principles.

Graphical Key Performance and Risk Indicators combined with Short Interval Cycles focus management effort on taking corrective action very quickly. The unique pro-active dashboards help turn around the reactive Management Information Systems and became a vital and integral part of the overall strategic management philosophy underpinning the Risk Based Value Management practice we have developed.

In a Risk Based
Oriented
Management
approach risk
managers assist
their clients in
filtering the noise
and distractions
along the way

IFQ

ISLAMIC FINANCE QUALIFICATION AND TRAINING COURSE

The IFQ is a ground-breaking qualification that covers Islamic finance from both a technical and a sharia perspective, providing the first international benchmark in the area of Islamic finance.

It provides delegates with an understanding of the influence of sharia in a business context and prepares delegates to hold key positions in the Islamic finance and takaful (Islamic insurance) industries.

The qualification and training course are appropriate for existing and new employees and those seeking a career in Islamic finance. Since its launch, the exam has been taken in over 40 countries.



Since its inception the IFQ has been highly acclaimed as it contributes to the widening and deepening of the skills of financial practitioners. We are confident that this third edition will further confirm its pertinence to the financial industry at large. ”

Raed H. Charafeddine
First Vice-Governor, Banque du Liban
Chairman, Advisory Council for Islamic Finance

Key Features of the IFQ

- ✓ Provides an essential knowledge of the general principles of sharia (fiqh al muamalat) and its application to Islamic banking and finance.
- ✓ Covers the different types of Islamic finance contracts and products available.
- ✓ Examines the practices used in the Islamic financial markets and the principles behind investment selections.
- ✓ Employing IFQ holders indicates that a company is contributing to the development and promotion of high ethical standards amongst its staff.
- ✓ Initiated and supported by the Central Bank of Lebanon (Banque du Liban).
- ✓ Awarded jointly by the Securities & Investment Institute (recognised by Ofqual, the UK government education regulator) and l Ecole Supérieure des Affaires (ESA).
- ✓ Available internationally.
- ✓ Offered in English and from 2010 in Arabic.

Who Should Attend?

All banking and finance professionals either working within an Islamic financial institution or intending to do so and any other professionals working in the field who wish to develop their skills and understanding of Islamic finance.



ACCREDITED TRAINING PROVIDER

- For more information on available IFQ and other Islamic Banking and Finance training courses, venues, prices and dates please contact **Cariska Pieters**, email CP@riskrewardlimited.com or ring **+44 (0) 20 7638 5558**.
- For more information on setting up a fully compliant Islamic Banking & Finance window within an existing bank or a new Islamic bank please contact **Lisette Mermod**, email LM@riskrewardlimited.com or ring **+44 (0) 20 7638 5558**.



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