



2014

A Year of Challenge for the Banking Industry



Also in this issue

- Global Banking Standards: A Long and Stoney Road Ahead
- How Auditors Can Overcome the Strategic Challenges Posed by Basel III
- Debt: Does It Continue To Be There?
- Banking in Emerging Markets – Female Entrepreneurs and Financial Literacy
- Managing the Risks of Social Media
- Star Trek Banking – When Disaster Strikes!
- The Bank for International Settlements and Large Exposures

Dear Subscriber

Bankers have generally become used to continual change. The pendulum of regulation is currently pointing towards greater challenge. Of course whether more regulation and what might be termed a safer banking industry actually fulfils the needs of the market are for you to consider. In this issue there is a theme of challenge running through all of the articles.

We start with looking at 2014 in terms of what we expect to occur and of course this follows into 2015. The global risks are still there and global indebtedness continues to rise, it is just that the banks are either unable or unwilling to take on the new market entrants effectively. Regulation appears within an article looking at the development of global banking standards and also the new rules from the Bank for International Settlements which address large exposures. Trying to change the ethics of an industry is never going to be easy and the lack of emphasis on profitability being at the heart of trust and robustness remains a concern. These new rules on large exposures provide greater challenges than you might expect and these will be particularly found in the developing world. Are they really required and are they cost effective? You can judge this after reading the article.

Basel 3 is still being implemented although the liquidity rules have been delayed, which is probably sensible since there is probably insufficient liquidity in the world to deal with such concerns. Here we look at the challenge for internal auditors in making appropriate recommendations in such a difficult and changing environment. We also look at dealing with disaster and trying to think the unthinkable in an article going where no author has gone before – Star Trek Banking.

The growth in debt is still very much here – which is the primary conclusion of the article on Debt. Of course as interest rates rise the increasing threat posed by this both locally and internationally will be a source for concern.

Two final articles look at the issues for women entrepreneurs in emerging markets and at social media. These are changing the risk profile of firms and indeed data security has risen significantly in the recently published Banana Skins survey from the Centre for the Study of Financial Innovation.

So there is as always a lot in this issue of the Global Risk Update which we hope you find interesting and thought provoking. In 2015 I am expecting even more to come through and an increasing demand for staff within banks to be appropriately qualified to meet the requirements of the market. This poses a challenge for both firms and for the institutes. For us we can promise that we will be available to meet the future needs of the market whether in accredited or tailored training, recruitment of consultancy. I look forward to hearing from you in the future to see how we can meet your needs.



Dennis Cox BSc, CFSI, FCA
Chief Executive Officer

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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 editor@riskrewardlimited.com

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2014 – A Year of Challenge for the Banking Industry

Global Risk Update Editor in-Chief Dennis Cox looks at some of the key issues that need to be faced and the likely direction of change both to the banking industry but also to the investment landscape.

There are a number of major changes currently occurring in the banking industry and this is creating both challenges and opportunities for the banks. In practice this will mean major change for many firms as they seek their role in the new banking industry paradigm. They will need to evolve into more cost effective and efficient organisations which add value to society, but there are many problems. In this article I look at some of the key issues that need to be faced and the likely direction of change both to the banking industry but also to the investment landscape.

The Structure and Business of Banking

Over the last 30 years we have grown used to the idea of ever larger banks undertaking a wide range of roles within both the commercial and retail business space. Many had grown into major institutions with a global footprint. These days are essentially over. As the rules developed in the light of the crisis are sporadically implemented inconsistently by regulators, firms need to consider where they need to do business and why.

In future as the Basel 3 and other regulations are increasingly implemented, it will be harder for banks to identify and undertake profitable business. The costs associated with the increased capital and liquidity required as well as the changing industry will all have a significant impact. Banks will need to look at each of the businesses they undertake and properly assess the profitability of activities undertaken including the likely costs of capital that will apply over the life of the product.

Since many banks do not have adequate activity based costing systems they are unable to properly understand the costs associated with the business that they are doing. This could mean that products are essentially being mispriced. In reality, pricing applied by banks does not always follow what might be termed normal accounting principles commencing with costs and adding margin to arise at a price. Instead the market price for such services is often driven by competitors all chasing the

same business with many of them essentially selling their products with an inadequate expectation of return.

Of course as we shall discuss later the uncertainty of the regulation being applied does make it even harder to set an accurate price over the product life time.

The consequence of this will be that banks will focus on niche activities where they are able to make an adequate return. The consequence for customers will clearly be increased costs and reduced competition between banks. However non banks will increasingly be seen, as the normal way to deal with many issues traditionally left to the banks and this will lead to profound change. Whether Boards of banks recognise fully the speed and impact of this dynamic will be illustrated by their ability to fully grasp the opportunities which come with these challenges.

The Impact of New Non Traditional Entrants to the Market

It is clear that regulators are concerned about two main issues. The first is that the failure of a bank could cause losses to taxpayers. The second is that personal deposits could be lost. They do not appear to have the same level of concern over wholesale,



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commercial or larger deposits, but smaller deposits do give a cause for concern to regulators. In protecting these assets the regulators are designing a regulatory regime that ensures that each bank has sufficient liquidity and capital to meet extreme circumstances. This approach has little to recommend it and would be akin to everyone having sufficient funds to deal with anything that they might insure. If you consider that you needed £500k of insurance cover than you would have to have the ability to get £500k in liquid assets. Essentially the insured becomes the insurer.

What these rules cause is a lack of growth in the global economy. The price that is now required to render the business profitable becomes inappropriate to the customer. Business overdraft rates of 9% above base now become commonplace but are clearly inappropriate to the needs of the market.

If a firm does not take deposits then it does not need a banking license and will not be captured by the Basel 3 regime. There may of course be some level of local capital requirements but they are unlikely to be of such significance. Consequently such firms are at a competitive advantage. Where are these funds? They are held by companies and other non-financial institutions. What we will increasingly see is new entrants that are not deposit taking institutions entering the market place and taking significant market shares. The growth of crowd funding in all of its guises is also a game changer. If you run a small business then crowd funding is likely to be able to provide you with a type of funding at a price and with a speed that banks are unable to match.

The consequence of this will be that banks will need to think carefully about what their role is likely to be in the future with much of the business that they currently undertake becoming unprofitable and also declining in market share. Free services will clearly need to become a thing of the past and many branches will close.

The Impact of Dodd-Frank

However there are other major changes afoot which have different impacts. In the US the implementation of Dodd-Frank has resulted in non-US firms needing to consider what business they are booking into the US. It will no longer be appropriate for such firms to use their US office as a booking centre for non-US domiciled activity and this will increasingly be repatriated to their home market. The only real alternative is to either purchase a US bank with a large capital base or reduce the level of activity conducted in the US.

What we are expecting is that the foreign firms operating in the US will really start to question both the activity conducted and the size of the assets maintained in the US. This is of course likely to be to the detriment of US banking since, once the business is reduced to the rump US activity the remaining business is unlikely to be profitable. We would expect even major overseas banks to exit the US market and the majority to significantly curtail their US business.

The disappearance of so many firms from actively operating in the US market will again remove competition in key

international banking sectors with a consequent increase in pricing for US customers. Again the effect will be experienced by the real business community and well intentioned regulation will have an impact that does not appear to have been fully considered.

The Change in the UK

The regulatory changes in the UK are also significant for some foreign banks operating in the UK, although the challenge is perhaps easier to overcome. The pressure is on for many of the overseas banks that currently operate purely through branches to convert their businesses into full subsidiaries. This will mean that the new organisation will be subject to the same liquidity and capital adequacy requirements as other banks operating in the UK.

If you are currently operating through a branch in the UK then the change of structure to a subsidiary is of course possible. The new firm will need to be separately incorporated and capitalised meeting the new capital and liquidity rules. New governance structures will be required including suitable non-executive directors, audit and remuneration committees. New reporting routines will need to be implemented together with ICAAP reporting. Of course the bank could choose to not deal directly with UK retail customers and may then be able to continue to operate as a branch but in many cases the remaining business alone may not be sustainable.

Another challenge will be to move the assets, liabilities and contracts to the new business and then to implement the revised compliance regime effectively. All of this will incur significant costs and we would suggest that may not be appropriate for all financial institutions.

The Change in Investment Banking

We are clearly seeing the end of the historic investment banking growth trend that operated until 2008. In 2014 there is some increase in IPO activity and we do expect that to continue throughout 2014 and into 2015. This is driven by a number of factors including pent up demand slowly being realised. There clearly are a lot of liquid assets available chasing suitable investment opportunities and with interest rates at historic lows equity investment remains one of the more interesting areas to consider.

Why then are investment banks becoming an endangered species? The fallout from the recent (or continuing) financial crisis places much of the blame on investment banks and this is clearly demonstrated by the size of the penalties that have been sought. This has bought home to Board directors and regulators the true level of risk that clearly exists in such activities.

Regulators and politicians will no longer accept the risk posed by an investment bank which is either attached to a retail deposit book or potentially poses a risk to tax payers. The only way to ensure that no such losses occur is to significantly reduce the level of risk inside the investment bank and that means a restriction on the activities conducted. In the US we see this through the Volcker rule

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inside Dodd-Frank essentially prohibiting proprietary trading whilst trying to maintain market making.

The investment banks used such trading activities to generate their profits while at the same time creating market liquidity. If the proprietary trading activities are removed the investment banks retain a rump business of trade execution, market making and long term fund creation. All worthy but, not as potentially profitable as the previous business. What we are seeing is the investment banks significantly reducing their activity with independent firms such as our subsidiary Niven Capital Limited increasingly being asked to design structures which historically would have been the exclusive domain of the investment bank.

We see this trend continuing into 2015 with a smaller number of investment banks chasing a smaller pool of opportunity with greater transparency, high costs and lower returns and non banks increasingly becoming involved in such activity.

Change in Retail Banking

Why do we still have so many High Street branches? What is really done there? When did you last visit a bank branch? Did the bank make any money from the transaction you undertook? One of the consequences of the banks needing to work harder to ensure that they are able to earn an adequate return is that areas such as branch banking come under threat.

The changing ways of working means that many transactions that would previously have been conducted in a branch will be conducted on-line or by phone. This trend is due to accelerate in 2014 – 2017 resulting in major change for the High Street. In a typical town you might have seven or eight bank branches. By 2017 this will have reduced to no more than one or two and in many cases to none. Countries such as Kenya have already made this change with in excess of 75% of payments now being made by phone in that country.

The banks will also be squeezed on their income. If an SME or individual previously wanted to raise funds their first and perhaps only option would have been to go to the bank. Larger firms can of course issue bonds and equity, but for the smaller firm this was not and still is not a realistic option. Accordingly the bank was the place to go to for loans and overdrafts, but that is no longer the case. Crowd funding has come out of the shadows and is increasingly becoming mainstream. With platforms such as Funding Circle having already provided almost a quarter of a billion GBP of loans they and a series of other new entrants will become the natural home of retail and SME funding. The change is starting and we would expect this to accelerate in the next five years. With banking overdraft rates at between 5% and 10% above base, there is plenty of opportunity for more nimble service providers to take significant market share.

However the capital advantages that the crowd funding industry currently enjoys over the banking industry will in our opinion increasingly be under threat. We do expect

increasing capital requirements to be placed on crowd funding platforms even if intellectually this makes very limited sense and will again try to prevent them from serving the community effectively.

With the challenge of a loss of a reason to exist in the High Street combined with the loss of key revenue, the trend for reduction of bank size is likely to occur faster than you might expect. In some cases radical solutions will need to be considered with famous names disappearing.

Change in the Derivatives Market

In previous articles we have expressed our concerns over the creation of a central counterparty with the increase in systemic risk that is self evident. That such central counterparties have effectively been designed using the model of the futures market with confidence levels of margin being insufficient to deal with a stress event only serves to illustrate the erroneous thinking which has led us to what may prove to be the next but one disaster.

As you increase the costs of an activity the commercial imperatives change and we are seeing that with derivatives. There are almost no commercial transactions that need to go to a central counterparty that could not have been better structured a different way such that they are not eligible to go to an exchange. Accordingly the reduction in derivative activity in the US market caused by the creation of the central counterparty which is believed to be around 80% has profound implications. For the banks another income stream has been severely curtailed.

Since the banks do not choose to sell the alternative structures which would serve the market better, corporations that formerly were hedging risk will cease to do so. At its most basic the costs of hedging will be so high that the commercial decision will be to let the risk run. Of course this serves only to move the risk from Wall Street to Main Street and renders corporations less secure. So what is bad for the banks is also bad for business. But worse we will see reduced liquidity in instruments and increasing bid offer spreads as a consequence of the erroneous decision. If we needed greater transparency this could be achieved simply by adding a reporting suite to the current SWIFT based ISDA interpreted confirmation process. That would have been cheap and effective. What we have is an expensive solution that most firms will not want to use that creates systemic risk rather than the former distributed and collateralised credit risk.

We are concerned that central counterparties might fail through a combination of unsustainable costs, low volumes and the eventual realisation that it did not need to be like this.

The Investment Market

We do not expect interest rates to rise in the US or UK this year and question the likelihood that they will rise in Q1 2015. We continue to be negative fixed income securities with a residual tenor greater than a year and will probably hold that position for the next twenty years. We are also

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negative gold in the short term and remain concerned that the Chinese growth story is essentially over for at least the next five years.

Are we in a recovery? It is hard to say. If this is a recovery it is clearly at best fragile. But there are asset bubbles being created. In many countries of the world we are seeing evidence that housing bubbles are being created. We do not agree with the concept that housing bubbles create wealth since they generally create poverty and unrest. Of course Basel 3 requires the implementation of countercyclical capital to counteract such bubbles although we doubt that these are likely to be called.

Another bubble is clearly occurring in investment prices being paid for firms that are at valuations which are clearly inflated. If a firm is being sold at 150 times profit something is really badly wrong and with regret there will be another stock market crash caused by the realisation that such firms are massively over valued. However since commodities and bonds are likely to remain depressed this crash will probably not take place until Q3 2015.

So for 2014 we believe that equities and property will perform well, with commodities and fixed income performing poorly.

All in all a difficult scenario for the banks to face, but face it they must. What you can be sure of is that there will be significantly more badly designed and ill thought through regulation which is technically suitable but practically a disaster.

The Commodities Market

We remain cautious regarding commodities generally and assets such as gold and oil particularly. However this is predicated in a global macro political environment which at best might be described as heightened. Looking at each of the main commodities:

1. Gold

As we have discussed before gold is actually not a very useful metal although it has perceived value. It has very limited commercial uses and to believe there will be a significant rise then you need to believe there will be growth in India and China. We are far from convinced that there is a major growth story in either market and accordingly anticipate that the market will remain subdued for the next three years. For 2014 we remain negative.

2. Oil and Gas

The geopolitical issues surrounding oil have been rehearsed in many articles, although perhaps the level of focus is changing. The growth of non-OPEC oil deliveries is also making a major difference. The most recent summary of exports is shown in the chart:

Some of the names here may surprise you, although these are the gross figures, not the net figures. Indeed it is anticipated that the US could overtake Saudi Arabia and even possibly Russia by 2017.

Of these countries Iran and Iraq are hardly producing at full capacity and questions exist over the level of investment in the Russian oil fields. Of the producers that are not on this list and could produce significant oil Libya and Nigeria are of clear interest. Looking at the list suggests significant disruption to a major source of supply becomes increasingly unlikely due to the global producer spread. With the price differential between gas and oil being at a historic high the expectation is that oil prices will remain constrained during 2014.

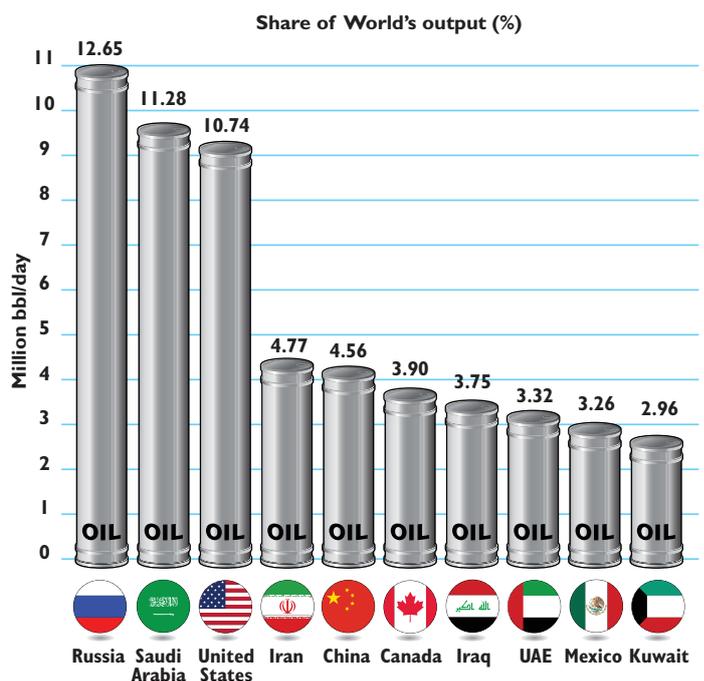
We do not expect there to be sufficient global economic growth to create the dual effect impact of an increase in the oil price and the gas price in the next three years. So on balance we remain negative oil and neutral gas.

3. Fixed Income and interest rates

Why does anyone still buy long dated fixed income paper? Given the yield curve in all major markets there is an expectation that such assets will decline on a mark to mark basis over the coming years. We do not expect a growth market in long dated fixed income securities for at least ten years and perhaps even longer.

The only real market is likely to be in assets where the redemption value provides an anchor to dissipate the effects of rising interest rates. As to the question of when rates will

List of Top 10 Largest Oil Producers in the World 2013



- See more at: <http://www.whichcountry.co/top-10-largest-oil-producing-countries-in-the-world/#sthash.n2GiknyW.dpuf>

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rise, trying to second guess politicians is always a high risk activity. However we cannot see any real reason for interest rates to rise in 2014, but do expect rates to rise at some time during 2015/2016. The ability of Central Banks and politicians to be wedded to policies that lead to low interest rates and potentially stagnation has again been written about many times. We will not revisit that here.

4. Food Stuffs

One of the more pleasing scenarios has been the decline in price of certain staple commodities. The 12.5% reduction in the wheat price since October 2013 is of course good for the global market if not for farmers. There has been a similar story with rice, for example, where there has been a 14.2% decline since August 2013. For everything that climate change has thrown at us to date there has not been a consequent increase in staple food prices generally. Again the limited growth in the global economy will not be pushing consumption and the China story could be a break on growth for a significant period to come. On balance we are neutral commodities.

5. Property

We are concerned at the growth in UK and US property prices. Once property markets are growing at 10% or more this is leading to the expectation of a bubble. Of course you will be thinking that the price recovery is both uneven and from a lower base. However given the lack of real growth in the global economy there is little reason for the increase other than the asset being a perceived store of cash and a limited supply restriction.

We do anticipate the growth continuing for the foreseeable future, albeit without any particular enthusiasm and therefore remain positive property (residential) in 2014. We have greater concerns over commercial property however. Looking at the major Cities of Europe and the US we can foresee a rise in commercial property but expect this to be at a discount to the growth in residential property prices.

6. Equities

Given the limited investment opportunities that appear to exist the equity market becomes one of the few places where growth can be perceived. Of course we are seeing assets coming to market at valuations which are mouth wateringly extreme. We continue to question these valuations and do anticipate a correction to the markets. However we do not anticipate this correction this year. Accordingly for 2014 we are cautiously optimistic regarding equity markets.

7. Predictions

One thing we are certain about is that the number of predictions will increase in 2014. It is the one prediction we can make with absolute certainty.

The author invites your comments via email to DWC@riskrewardlimited.com



Global Banking Standards: A Long and Stony Road Ahead

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The Global Financial Crisis – 7 years on

Almost seven years on after the Financial Crisis first started taking hold in August 2007, Global Financial Institutions are still reeling from what would become a revolutionary change to the fabric of the markets: with regulation hitting firms hard and many still repaying governments that bailed them out in the first place, one could argue that all these regulatory initiatives have also helped increasing global banking standards and the way in which firms are conducting their business.

Furthermore, with the advent of the Financial Conduct Authority (FCA) in April last year, a regulator with a key focus on “conduct”, one would expect that this has had a major impact on firm’s culture and behaviours. Certainly, the regulator’s “sticks” in form of considerably sized fines may somewhat represent a fear-factor and have certainly helped raising market awareness of increased regulatory scrutiny. On the other hand, as recent events at the other UK regulator, the Prudential Regulatory Authority (PRA) have shown, even the regulator’s own conduct may be occasionally called into question.

Having said that, with “Conduct risk” still not been clearly defined by the regulator and leaves considerable ‘headroom’ for interpretation on the part of both firms and individual employees. I have previously argued that a clear definition of this term is needed in order to provide a clear measure by which firms’ and their staff can be benchmarked. Unfortunately, with the recent publication of the FCA’s “Risk Outlook 2014”

document in March, no further clarification or definition of this term has been forthcoming. The regulator has missed another glaring opportunity to establish a definitive standard.

More work and education is required in this space as the FCA and the “Conduct risk” theme are not going away anytime soon given the role they have to play in interpreting and implementing standards.

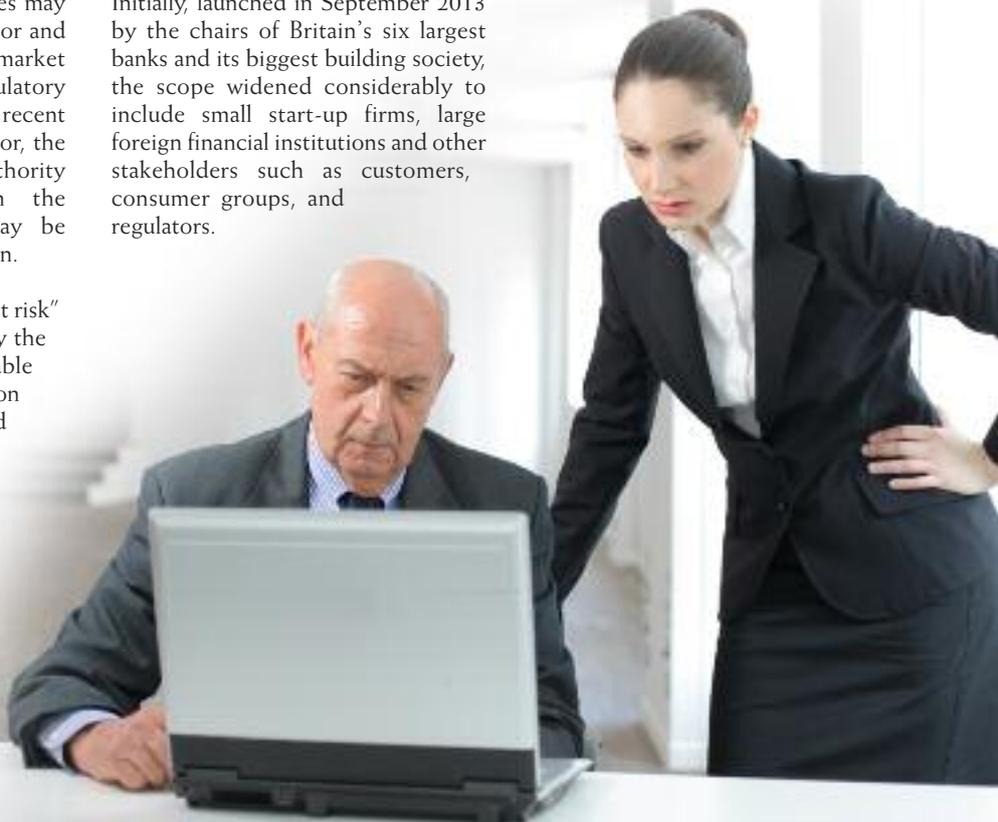
Sir Richard Lambert’s Banking Standard review in UK

At the end of last year, Sir Richard Lambert was tasked with a review of banking standards in the UK, with the ultimate objective of raising standards, competencies and behaviours of financial markets employees in the UK.

Initially, launched in September 2013 by the chairs of Britain’s six largest banks and its biggest building society, the scope widened considerably to include small start-up firms, large foreign financial institutions and other stakeholders such as customers, consumer groups, and regulators.

The 26-page consultation paper raised 19 questions seeking responses on areas such as:

- Conduct, Culture & Standards in Banks
- Necessity for a collective approach to participation The anticipated role and purpose of the newly proposed banking standards body
- That standard body’s scope and credibility
- Need for a more pro-active approach to managing ethical issues
- Implementation approaches for banks’ code of conduct
- Proposals to operate as an umbrella body for other professional institutes
- Firms’ in-house training academies and certification processes
- Proposed metrics and benchmarking exercises
- Standard body’s governance, self-reporting and “kite-marking”



Global Banking Standards: A Long and Stony Road Ahead

The consultation period ran from December 2013 to March 2014 and, according to the Consultation website (<http://www.bankingstandardsreview.org.uk/>), the 150 responses received were from individuals, academics, financial institutions, professional institutes and trade associations.

Given the particular focus of the proposed standard body on behaviour, conduct, ethics and in particular training as the main means to improving conduct it is somewhat surprising and disappointing how few professional training providers have actually submitted a response. They may have missed a great opportunity to make their voices heard.

Sir Richard's findings have been published on 19th May 2014 (<http://www.bankingstandardsreview.org.uk/assets/docs/may2014report.pdf>) and it remains now to be seen where this will take us going forward, but it appears that a number of large financial institutions are backing this campaign.

Firm's skills gaps – and how to close them

Having recently spoken to a number of high profile leaders at a variety of global financial institutions on the subject of professional standards, a few issues quickly became obvious:

Soft skills gap

Many firms are currently suffering from soft skill gaps, particularly around presentation, communication and comprehension skills. More importantly, they are actually struggling to close these gaps.

Lack of knowledge about what's on offer

The leadership at many firms is not aware which globally accepted and accredited professional qualifications are available to them and their teams.

Maybe this is an area where a banking standards body could play its part and add value by providing independent and unbiased advice to financial institutions.

Furthermore, it's not only senior managers who are left in the dark - it's also the staff themselves. Often HR departments or Learning and Development teams are not aware either, hence staff are currently lacking an informed in-house source that could help them in planning their career development path.

Global Financial Institutions are still reeling from what would become a revolutionary change to the fabric of the markets

Lack of qualifications and knowledge management

Many firms do not appear to have a general awareness of their employees' professional qualifications. More

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shockingly, many firms, including some of the largest players currently lack a learning or knowledge management tool that facilitates the ready identification of their employees professional risk qualifications such as the Associate Professional Risk Manager (APRM) or Professional Risk Manager (PRM) designation (awarded by PRMIA) or any of the professional certifications from the Chartered Institute for Securities and Investment (CISI).

Collecting and aggregating this information into a simple database or a similar tool would be fairly easy to achieve. However, the value added from this information is multi-faceted: it would enable firms to develop a clear picture of their staff make-up and their cumulative professional capabilities.

Furthermore, it would allow them to provide clear and transparent evidence to regulators that their staff are fit and proper to undertake their activities – the kind of hard evidence which regulators are increasingly demanding.

Last but not least, it helps both firms and staff to develop clear learning pathways for their career development and gives the firms a much clearer forward-looking view when developing succession plans ('living wills').

The Long and Stony Road Ahead

As most western economies are gradually recovering from the financial crisis and some of the bailed-out banks are releasing the taxpayers from their burden and moving back to becoming private institutions, it is important that lessons learned will not be forgotten. Continuous professional education is one of the key cornerstones in passing on the knowledge and raising professional standards globally.

With that ultimate goal in mind, a lot of work needs still doing in terms of improving professional standards and behaviours in the financial services industry, particularly in the following areas:

- **Continuous professional education or CPD.** This is particularly important as markets

are moving quicker than ever and employees dealing with "other people's money" need to have the right tools at hand in order to do a good job. As such, their professional education needs to be fit for purpose and a good university qualification is not enough - much more is needed.

- **Soft Skills.** These are often overlooked, yet they are equally, if not more important, than hard, analytical or quantitative skills. The reason is simple: Banking in its widest sense is really about 'dealing with people'. That requires solid capabilities to communicate, both verbally and in writing. It also requires listening skills, understanding as well as being able to asking the right questions of the business.

Without these skills, a risk manager for instance will not be effective in challenging the front office and unable to understanding the risks business is facing.

As one senior executive at a large financial institution recently explained to me in no uncertain manner, he has been considering hiring a professional financial journalist into his team for some time now, as this would be a person very good and proficient at understanding complex financial contexts - and, more importantly - their ability to express thoughts clearly in both, writing and speaking.

- **Definitions of terms.** The lack of definition of "Conduct risk" by the FCA, although having the term "Conduct" in its name, is but one example. Missing Unique Trade Identifiers (UTIs) and Legal Entity Identifiers (LEIs) are another one. How does anyone know what a certain term means, if it's not being defined properly by anybody, including the regulators? More clarity is needed as well as more courageous leadership to providing such clarity.

- **Out of the box thinking.** This is not something that is currently really being encouraged for a variety of reasons: Firstly, typical

job descriptions at firms do not encourage interconnected thinking or strategic, 50.000-high mile views. Staff are more than anything else pushed to meet their semi-annual or annual performance targets, and to focus on their own desks, cubicles etc. - almost as the exclusion of everything and anyone else. Yet, in an interconnected modern world it is more important than ever to understand: what is going to happen when someone's desk, cubicle or workplace and where could it end up (including on the front page of the Financial Times or Wall Street Journal).

The other one is, sustainability, i.e. a more medium- and long-term view. Both require a change of culture and that can only come from the top of firms and then cascade down through the corporate fabric of a institution.

In order for the financial markets to improve, not just in the UK but globally, more clarity, transparency and continuous education is needed. It's a long and stony road ahead - but that does not mean it cannot be mastered if we are all pulling together.

In closing, let me cite one of my favourite essayists and poets, Ralph Waldo Emerson, who wrote: **"Life is a journey, not a destination."**

With that in mind, let's travel pulling together in developing better standards and a new foundation for a stabler and resilient global financial system for which another failure is not really an option.

The author invites your comments and feedback via email to MK@riskrewardlimited.com

"Life is a journey, not a destination."

Ralph Waldo Emerson

How Auditors Can Overcome the Strategic Challenges Posed by Basel III

Basel III is a gamechanger for auditors as it is the singularly most important factor in linking regulatory requirements to strategy. It is now virtually impossible for auditors to focus on the former without thoroughly understanding the implications of the latter. Jonathan Ledwidge, Director of Risk & Internal Audit at Risk Reward Limited, asks how should auditors be approaching this task?

There was a time when auditors were told that they should focus on risk, internal controls and governance—and perhaps many are still being told that.

Alternatively, while it is accepted that some understanding of the business in question was always critical to the success of any audit, auditors generally spent very little time assessing and challenging the actual strategy. For the most part many auditors were content with confirming that a document outlining the strategy existed.

However, the far reaching implications of the Basel regulations and the stringent requirements of Basel III in particular means that it has now become vitally important that auditors have more than a rudimentary grasp of the business strategy.

The Legislative Force That Is Basel III

Basel III was created as a response to the Financial Crisis of 2008. Reactions to the legislation have varied depending on one's particular perspective – public, government/regulator or banker.

There is no question that banks are held in very low esteem and the reality is that no amount of legislative or regulatory action short of closing many of them down would have been deemed satisfactory in the eyes of the public.

There is no question that the response of governments and regulators has been driven by much of this angst and many within the banking community still believe that what came out of Basel III was overkill. It includes:

- Increased Minimum Capital Levels
- The addition of a Capital Conservation Buffer
- The further addition of a Countercyclical Capital Buffer
- Greater Restrictions on Instruments Eligible for Consideration of Capital
- A Liquidity Coverage Ratio (LCR)
- A Net Stability Funding Ratio (NSFR)
- A Leverage Ratio

Despite, all of the above, the regulators did not stop there. Not wanting to leave anything to chance they added a further list of items that attracted higher capital charges. The list included:

1. OTC Derivatives
2. Exposures to other Financial Institutions
3. Systemically Important Financial Institutions (SIFIs)
4. Counterparty Credit Risk (CCR)
5. Securitisations

The impact of this on both the organisation and the institutions audit functions has been huge. In the case of the former it has meant huge investments in people, systems and processes in order to both demonstrate and achieve regulatory compliance. The impact on the audit function has been similarly seismic in that it now has to ensure that:

1. The board, management, governance and internal control structures responsible for responding to this regulatory avalanche are up to the task



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2. That risk and compliance functions have the professional competence and resilience to effect the necessary changes
3. The IT, Systems and Processes necessary for effecting the actual change are:
 - a. Adequate
 - b. Effective
 - c. Secure
4. There is a high standard of integrity in the quality, transmission and reporting of data
5. The quantitative models that support the calculation of credit, market and operational risk exposures are subject to appropriate validation and control procedures
6. That the fulfilment of the Basel III implementation is not merely an additional task but that it is seen as integral to as well as fully integrated with the business and decision-making processes at the tactical, strategic and operating levels.

Items 1-3, it can be argued, are consistent with the traditional audit function.

Item 4 is also consistent with the traditional role of audit but is now even more important given the need for regulatory reporting of compliance and adherence to new standards – failure in this arena now has huge regulatory and reputational consequences.

Item 5 presents its own uniquely technical challenges while item 6 brings with it totally new and different challenge – understanding the strategic imperative.

The Strategic Impact of Basel III

In the eyes of many bankers and some independent observers the imposition of Basel III was simply an attempt by the regulators to throw as many rules at the banking industry as they possibly could in the hope that this would postpone the onset of another costly disaster.

Never the less, the strategic implications of this change are huge.

In the first instance, giving that capital has become so costly the strategic and competitive analysis of any business now literally begins and ends with what it costs in capital and

liquidity terms – not what new market or new business the head of trading wants to pursue.

This alone is a huge change in investment banking in particular from what was previously an opportunistic model i.e. the pursuit of market position in a product in order to match or outdo the competition, to a model where banks will (or should) compete on the basis of the most capital efficient products.

This new reality is evidenced by the fact that many of the banks that were huge players in the highly capital intensive commodities business, the so-called “Wall Street Refiners” such as Barclays, JP Morgan and Morgan Stanley, have either exited or are in the process of exiting that business.

Yet, this change is not limited to complex trading products as increased capital requirements means increased pressure on loan margins. The logical consequence of this is that rather than being judged by the size of their loan books and bloated balance sheets, the new emphasis on capital efficiency and liquidity will mean that banks will now be judged on credit quality and pricing.

This changing dynamics of banks, products and markets will not only significantly alter the competitive landscape but also bring new operational and tactical challenges.

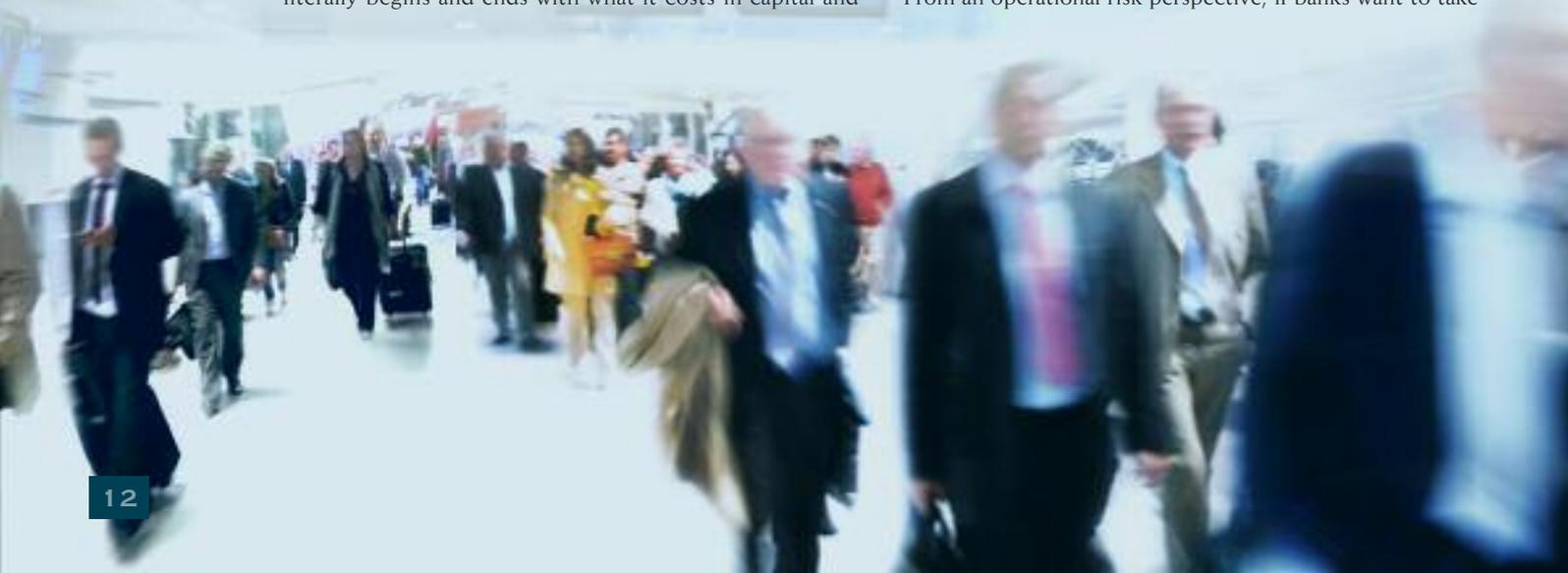
The Tactical and Operational Challenges of Basel III

Costs, operational efficiency and data management present their own tactical and operational challenges in the post Basel III world.

Reduced margins and cost efficiencies are driving real changes in how some units operate. For example it has further accelerated the trend of replacing traders with computer programmes for some products.

Unfortunately, electronic trading is just one part of the business which has come under increased regulatory scrutiny and this has profound implications for the way in which such services are being provided and received.

From an operational risk perspective, if banks want to take



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advantage of the much lower capital requirements of the Advanced Measurement Approach (AMA) then they have to develop and execute a comprehensive methodology for monitoring and controlling operational risks. This pursuit of AMA status is normally a vast undertaking which will considerably impact how business and business processes are conducted and managed.

Basel III also brings with it new and greater demands in respect of data integrity and management. In Basel III terms if there are significant errors in regulatory reporting then there might also be significant errors in strategy. Therefore, the validation, collation and integration of the data that supports both the internal decision-making process and the external reporting requirements are all highly critical tasks—one made all the more daunting by the industry's history of legacy systems, rapid expansion and poorly integrated business units.

As such, banks can no longer afford to have inefficient, poorly integrated or poorly managed entities and business units which are subject to frequent operational losses. Operationally efficiency is no longer just an internal management goal it is now a regulatory imperative.

The Role of Audit

It will be almost impossible for auditors to perform their duties without giving due consideration to how each of the above elements impacts the scope of their work and whether or not the business is being conducted not only in accordance with management's objectives but that it is also consistent with regulatory best practice.

From a general perspective the idea that an auditor should focus not just on the actual regulation but on regulatory best practice is not really new. In the normal course of their work auditors are required to do just that, especially when they incorporate letters and other communications from regulators in forming their judgement. Yet, the concept is now even more important for two reasons. They are:

- Basel III and its US equivalent Dodd Frank have more than any other pieces of regulation inextricably linked the fate of individual banks and the entire industry to strict regulatory adherence
- Regulators are also now responsible for reviewing the work of the internal audit function

Consequently, the only way that auditors can properly effect

their responsibilities is by developing a full and complete understanding of the strategy, its implications, risks and possible pitfalls in both business and regulatory terms, while understanding the linkages between them.

Fortunately for auditors there is one process which readily facilitates such an approach and it is the audit of the Internal Capital Adequacy Assessment Process (ICAAP).

Auditing the ICAAP

The most important thing that can be said about the ICAAP is that, despite the requirement for annual reporting, it is a process. As such, in order to be effective in auditing the ICAAP auditors must be as concerned with the process as with its outcome.

The reason for this is that the ICAAP, at least in theory, brings together all the elements of business, risk, finance, credit and compliance in order to determine how the institution can meet or better still reconcile its objectives with the demands of the regulator.

The ICAAP directly links the usage of capital and liquidity with the operational, tactical and strategic objectives and/or limitations of the institution and thus requires a comprehensive understanding of all these interrelated elements.

The ICCAP is the process for testing and evaluating all the assumptions on which management seeks to place reliance on in executing its mandate. As such, in order to be successful, the ICAAP must have the full support and approval at the highest levels of the institution.

By embracing the audit of the ICAAP and ensuring that the governance, inputs and dynamics of the process are consistent with their institution's size and complexity, auditors can significantly improve their understanding of the business and with it their ability to audit it.

The author invites your comments via email to JL@riskrewardlimited.com

huge players in the highly capital intensive commodities business, the so-called “Wall Street Refiners”, have either exited or are in the process of exiting that business



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Debt: Does It Continue To Be There?

Author Flora Prieto, a senior risk management specialist based in Madrid, contributed this article, aimed to reflect on debt's role in the current economic environment.

Many voices worldwide over the last few months, are insisting on the need for recovering financial sector's capability for funding economy's growth. IMF papers, ECB reports or AFME roundtables are just some examples of this.

A quick glance to the latest Euro Area Bank Lending Survey (ECB, 2014) reveals the existence of a wide array of factors which explain debt's vanishing. The problem gets even more complex when taken into consideration the role played by the different participants in the debt chain. Applying the classical perspective of a supply-demand relationship, the movements on the supply side in response to more restrictive regulatory frameworks alongside changes seen in the traditional banking business model contributed towards pushing down the demand curve. As a result of all this, customers suffered from credit restrictions. The "contagion" effect to the rest of the economy was already served with the added element of the loss of faith in some of the market participants. Tactics that have always worked seem not to work any longer. Where does the problem lie?

Getting back to the survey mentioned above, it is worth mentioning the relevance that management aspects, external circumstances and derived effects, are playing in making it extremely difficult to get out of the crisis circle.

Banks acknowledge the tightening in their credit standards. However, as they explain, is not simply the consequence of downgrading customers' creditworthiness. Internal aspects associated to their costs of funds and access to markets' financing is resulting key for understanding the persistence in this bank's attitude. Also the external macroeconomic environment does not seem to have found its way up towards a

consolidated recovery. The worse consequence is the freezing effect on demand. A lower level of capital investments highly precludes the possibilities for further expansions of the activity over the long run. If accompanied by less available operating funds, the overall result is the movement towards a cash economy in which trade financing and credit policies have not much to say.

The list of Financial Soundness Indicators of the IMF includes as one of its categories the "Encouraged FSIs for Deposit Takers". Among the measures being monitored and updated on a quarterly basis are the Customer Deposits to total (non-interbank) Loans and the Spread between Lending and Deposit Rates. Considering the existing available data corresponding to EU countries, it can be observed that with the exception of some heavily service oriented economies like Luxembourg or Malta, the rest follow a trend where the level of deposits are lower than the loans. A similar pattern of behavior is being displayed by the BRICS. However, when looking at the leading developed economies of Japan and the US, deposits exceed the amount of loans, approximately by one third. On the other hand, spreads show a wide range of fluctuations within each of the analyzed group of countries. The highest values would correspond to some of the BRICS. Brazil with 852 basis points and Russia with 392 are examples of this. In Europe and developed economies, with the exception of just a few countries facing serious financial difficulties like Greece or Romania, values fluctuate between 130 and 300 basis points.

Shifting the analysis towards complementary banking activity sources, the indicators of Gross Assets and Liabilities Position in Financial Derivatives to Capital show a higher importance of the latter respect to the first for most of the analyzed

countries, with the UK and Ireland the ones with higher proportions of capital invested in this type of instruments.

How are markets behaving in respect to debt? In terms of issuance, available data seems to confirm that 2013 has been a consolidating year for the recovery trend started one year earlier by the corporate bond market. However, some aspects are worth noting. On one hand, the significant geographical differences which can be observed across the different world regions. On the other hand, the increasing importance of riskier debt products likes high-yield bonds.

A comparison of research reports referred to the same period of time and elaborated by similar institutions, present in different parts of the world like the Association for Financial Markets in Europe (AFME), Asian Securities Industry and Financial Markets Association (ASIFMA) and the Securities Industry and Financial Markets Association (SIFMA) allows one to see the existence of relevant differences. Focusing on the issuance, investment grade bonds continue to represent the most important part of the market. However, as mentioned above, high-yield ones are becoming more present. While in Asia they roughly represent around 9% of the total volume issued, in the US, approximately one-fourth falls within this category. In Europe, its acceptance continues to increase which results in the possibility to find issuers from all countries, including the emerging markets of the former Eastern Europe. In the Asian market, roughly one-third of the total is sovereign high-yield. Asian securities' spreads are slightly higher than US and European ones for investment grade bonds, getting narrower, almost equal for high-yield corporate. In terms of maturity, Asia continues to be highly receptive towards perpetual bonds, the bulk of the issuances would pursue time horizons below five years

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in opposition to European ones with a tenor between five and seven years.

If the attention is being shifted towards the issuers, telecoms lead the European figures followed by finance firms. In the Asian market, this secondary place corresponds to real estate companies. Other types of industries prefer other debt alternatives. Thus, if considering leveraged loans, it would be healthcare, professional services and transportation companies the main issuers in Europe. This is a market that on a global basis, more than tripled the volume of high-yield bonds. As with bonds, it has the US as the most important originator.

Roughly 80% of the high-yield bonds' issuance proceeds in Europe go to repayment and refinancing of debt and general corporate purposes. This impacts, negatively, on a company's financing costs, deteriorating its margins while making it necessary to postpone decisions on investment plans and possible further expansions.

This situation results more understandable when the picture gets broader and banks funding difficulties are being analyzed. The ECB survey highlights the negative consequences that the sovereign debt crisis is having

on bank's funding conditions and on their willingness to grant loans.

The above mentioned data confirms that corporations, markets and investors continue to be interested in debt as a financing alternative. The problem lies on the fact that access to these funds through financial markets are very expensive, in terms of all the associated transaction costs it entails. Furthermore, they do not have enough capacity as for satisfying most of the company's needs. The first aspect precludes SMEs from the possibility of having access to this financing alternative as they do not have neither enough resources for spending on this nor a recognized creditworthiness. The second is, partly the consequence of the limited access in terms of participants to these markets. They were not created with the purpose of being the sole financing provider.

Everything related to banks' funding seems to worsen. The ECB survey shows deterioration in both retail and wholesale funding over the last quarter of 2013, mainly due to increasing difficulties when dealing with short-term instruments like deposits, money markets and debt securities. This imbalanced situation is seriously affecting financial institutions, making it extremely difficult for them the

recovery. Customers are willing to borrow; they need these funds, in order to put new ideas to work pushing the economy forward. On the bank's perspective, they need to get over funding difficulties for moving into a position in which it would be possible to generate new business.

Up to now, economic crisis characterized themselves by being one-time events that could last a longer or shorter period, with a cyclical character as they show up after a certain number of years, but during which, economic agents had to struggle mostly with restrictive economic conditions. Even when, on some occasions, some firms redefined their business as a way for giving answer to the new environment, this was always done as an outwards process, without affecting the most basic concepts of their business model.

The current crisis seems to be more of a circle type. The challenge for banks seems to be, first in transforming it into a linear one, so that new advances can start to take place.

The author invites your comments via email to JK@riskrewardlimited.com

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Banking in Emerging Markets – Female Entrepreneurs and Financial Literacy¹

Dr. Natalie Schoon is an internationally renowned expert in finance. Following her most recent research in financial inclusion and financial literacy, GRU asked her to share her views on the increasing number of female entrepreneurs and their borrowing habits in developing countries.

Although in developed countries it has become more common place to see women in the workplace or other public functions, this is not necessarily the same in emerging markets. In many countries such as Iraq, and Afghanistan as well as other Asian, African, and Latin American countries, women are a lot less present in the public eye. Interestingly enough, this does not mean they are less active, it just means they tend to be busy behind the scenes. This situation is, however, changing and anyone in the business of lending, and investing best take note, because these women are a force to be reckoned with.

Even though men are typically involved in public functions such as business and politics, women tend to be the strongest drivers of economic and social development. Although it is generally the husband, father, or brother who officially owns the company, deals with banks and clients, and reaps the financial benefits, women are more likely to make the important business and personal decisions, and undertake a significant share of the actual workload. In part as a result of high-profile publications like the Dress Maker of Khair Khana, detailing the story of Kamila Sidiqui, and for another part due to specific female oriented support programmes run by NGOs and international aid organisations, there is an observable trend for women to take control of their own enterprises. Many of these small



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enterprises have started from home, and although they provide a reasonable income for the family, they don't often grow beyond this stage, mostly due to a lack of access to financial services.

Financing female owned MSME enterprises appears to be a good business proposition, but they do have different requirements from male borrowers. For starters, research shows that female borrowers are much more likely to repay their loans on time and in full. In addition, personal experience tells me that the average amount women borrow is typically lower. Take for example the case of two saffron cooperatives in Afghanistan. One is a male lead co-operative, the other is run by a woman. Both needed to expand their packing facility, and both are a similar size. The male lead co-operative approached a financial institution with a request for USD 500,000. Although a justification for the amount was provided, the amount was obviously at least twice as high as what he really needed. The lady requested USD 100,000 which was probably a little on the low side, but her request was much more balanced. Female borrowers are more conservative, will consider their ability to repay in a worst case scenario, how much money they need to look after their family, and what the business can comfortably absorb at its current stage of development. Men, to the contrary, will go by the notion that bigger is better and deal with the (potentially negative) consequences later.

Financial Literacy – Who Takes Responsibility?

An important element of providing much needed access to finance is associated with financial literacy, or the understanding of money. Who provides this type of training is technically irrelevant although banks, MSME finance providers, and governments could play a significant role in this area.

From the borrower's perspective, whether they keep their money in a bank or in a jar at home, there are four key elements to consider for individuals as well as businesses: earning, spending, saving, and borrowing.

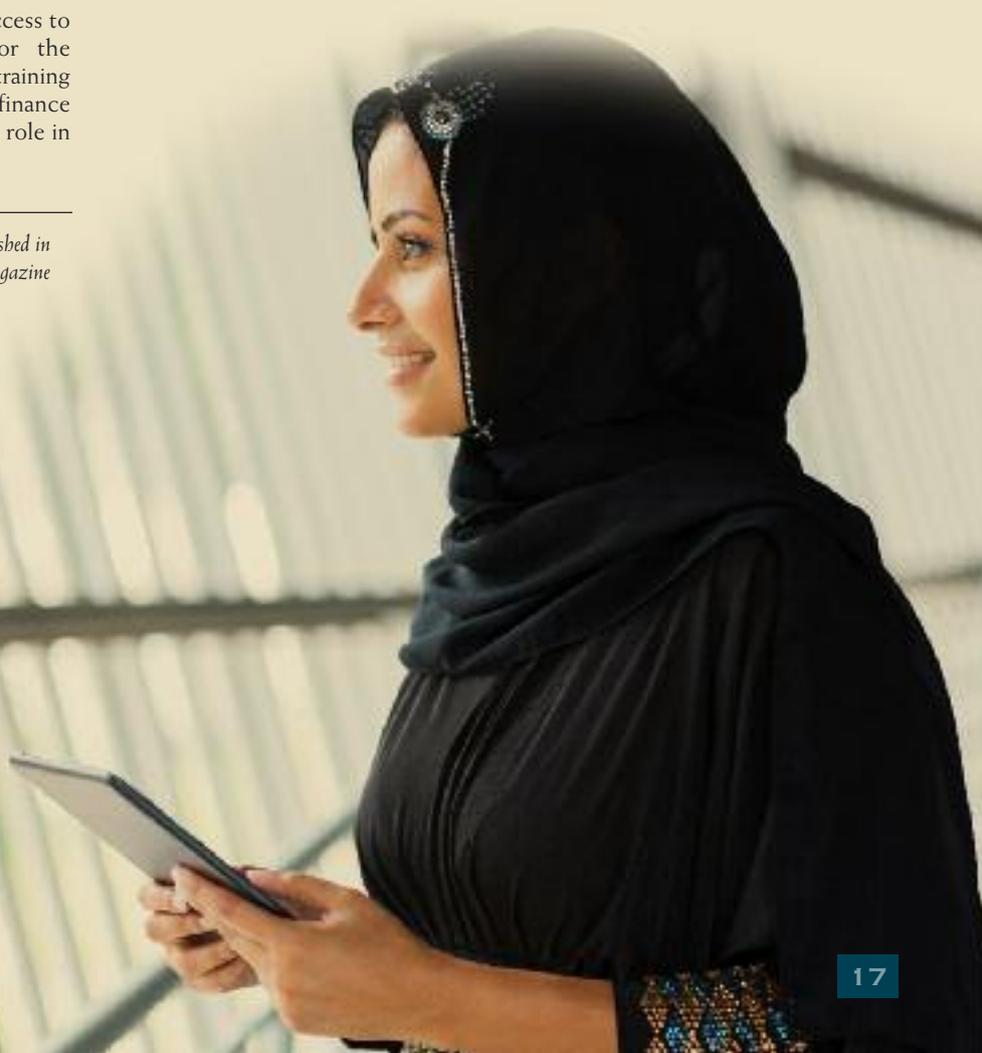
The underlying principles are generally quite simple and have certainly been hammered into me when I grew up. You don't spend more than you earn, you save for something you really want, and only in exceptional circumstances do you take out a loan. In the end any loan will have to be repaid, occasionally just the amount borrowed but more likely there is also an additional interest or profit charge.

Understanding how interest rates are determined and how banks function is important to enable the borrower to assess the impact of savings and borrowings on personal and business budgets. Banks often are able to help with this, but it has to be considered that the primary purpose of the bank is to make a commercial profit from lending. It is therefore of the highest importance for anyone to understand their own budget, financial needs, and possible solutions prior to entering into a conversation with a financial institution. No matter who provides the information, it is the responsibility of the user of the information to make sure they understand what they get themselves into.

The author invites your comments via email to NS@riskrewardlimited.com

¹ This article is based on an article titled 'Financial Literacy' published in the inaugural edition of *Nina – The Economic Empowerment Magazine for Iraqi Women Everywhere* (April 2014)

² Lemmon, G.T. (2011) *The Dressmaker of Khair Khana*



Managing the Risks of Social Media

Jeremy Swinfen Green is a Principal Consultant of Social Media Risk Consulting Ltd. He contributes the article with the intention of explaining that, as well as offering many opportunities, social media present all organisations with substantial risks but that these risks can be managed effectively.

Social media? Where's the risk in that?¹ After all, the great majority of organisations use social media for marketing. There are some very obvious benefits, not least "free" advertising and the deeper engagement with consumers that companies can create through platforms like Facebook, YouTube and Twitter.

But there are also some very real risks that are attached to social media. These risks exist whether or not your organisation is using social media proactively for marketing or PR. And they are not just IT risks – because most concern people rather than technology. As a result, normal digital risk management, which tends to focus on cyber-security, is often insufficient protection.

What is social media risk?

Most social media risk concerns the potential for people to say something inappropriate on public social media platforms. This can result in problems with financial or communication compliance. Saying the wrong thing can have damaging effects on brand and on sales. And it can even cause HR and recruitment problems.

Why is social media risk such a problem? This is simply because it exists on the internet, which gives rise to a number of issues:

- Social media content is potentially permanent. Say something online and your words will be recorded on a server somewhere, and the chances are that someone will be able to find them in the future. Yet many people think of it as being

ephemeral. But even with Snapchat, the handy app that allows you to send pictures that self-destruct after a few seconds, supposedly ephemeral images can be recorded using screen capture

- Many people think of social media content as being private, when in reality it is often highly public. You can choose your Facebook privacy settings but you can't prevent people you link to (who may well not be genuine friends) sharing your content with other people if they want to
- Many people think of social media as being somehow "unofficial" and outside the law, failing to realise that any words can have a legal implication in the right (or wrong) context
- Social media content is, by definition, easy to share, and as a result content can be circulated across the whole globe very rapidly, especially when that content gets picked up and amplified by more established media platforms such as newspapers
- It is relatively easy to remain anonymous when you use social media, allowing people to say things that are essentially unaccountable

Personal or professional?

For most organisations though there is another factor that increases the difficulty of managing social media risk: the fact that corporate, personal and professional spaces tend to blur in social media.

Only a small minority of employees are likely to be active on "corporate" social media accounts, contributing to

a company-owned discussion board perhaps or writing a blog piece for their employer.

However, most people of working age have "personal" social media accounts such as a Facebook page. And as often as not something to do with their working life will creep into their private social media activity, even if it just a comment about the company Christmas Party or an expression of frustration with a client.

As well as their own "private" Facebook accounts, many people also have "professional" accounts, perhaps on Twitter or LinkedIn, which they use for personal PR and to advance their careers, and where they may well be talking about their employer.

This is the danger. Any organisation should be able to manage content on their corporate accounts (although there are plenty of examples where this hasn't happened). The content on the personal and professional accounts is far harder to manage. But it can still have an effect on the organisation.

The IBM Social Computing Guidelines put it like this: "The lines between public and private, personal and professional are blurred in online social networks. By virtue of identifying yourself as an IBMer within a social network, you are now connected to your

¹ Eagle-eyed sticklers after grammatical exactitude should note that I sometimes use "social media" as a singular noun representing a type of internet application that allows people to create and share content and to participate in online networking.



colleagues, managers and even IBM’s clients. You should ensure that content associated with you is consistent with your work at IBM.”

Size of the risk

The effect of adverse social media content can be massive. In April 2013 an organisation called the Syrian Electronic Army was widely reported as having hacked into the Twitter Account of Associated Press where it sent a potentially disastrous tweet, falsely reporting two explosions at the White House and injury to the President.

The initial response was panic on Wall Street with the Dow Jones dropping 100 points and \$140 billion being wiped of the S&P500 index for a short period.

Of course most of the time social media doesn’t represent anything like such a large risk. In fact often any damage caused is limited to people in the marketing community laughing at a brand. But nonetheless the risk can be substantial: Directors have been fired for irregular financial disclosure (US retailer Francesca), brokers have been fined for inappropriate marketing (Jenny Quyen Ta), and client accounts lost for rogue employee tweets (consultancy New Media Strategies which lost Chrysler).

There are bigger stories too. Take Kryptonite Locks: one of their bike locks was “outed” as being easy to pick in an online forum; the post went viral, leading to massive reputational damage and costs alleged to be around

\$10million. And some people have linked a 10% drop in the value of United Airlines in July 2009 to a video posted on line by musician Dave Carroll singing about how “United Breaks Guitars”. Of course you don’t need social media to destroy your business (remember Gerald Ratner?) but it helps.

Across the board

The negative effects of social media can be felt right across an organisation and they are not all to do with organisational reputation, as some people assume. Many risk areas are concerned with profits, while others stem from laws and regulations, and there are considerable risks in the HR area as well.

Because of the widespread nature of social media risks it will rarely be appropriate to have social media managed by a single organisational function, such as marketing. Ideally

there will be a cross-functional team (marketing, legal, IT, finance, HR, operations) overseeing the risks with an experienced executive in charge of “triaging” any incidents to the appropriate members of the team.

Types of risk

Risks to profits include:

- Entering into or altering contracts accidentally
- Losing Patent protection
- Being sued for stealing 3rd party IP
- Being sued by a client for disclosing confidential information
- Loss of control of social media assets

Risks to brand reputation include

- Rogue employee tweets offending customers
- Discovery of obsolete marketing content
- Customer complaints escalating into a full scale PR crisis

Risks to employee management include

- Bullying by colleagues
- Intrusions on staff privacy
- Employees being put in physical danger
- Damage to organisation’s reputation as an employer

Risks from legislation include

- Publishing illegal content e.g. incitement to hate
- Inappropriate disclosure of financial information
- Libel suits
- Fines for illegal marketing from industry regulators



How is risk triggered?

Risk events can be triggered by a variety of factors, both internal to an organisation and external.

The Board

Internally, risks start with the Board. If there is insufficient oversight, if executives are not held to account, then social media risks will increase. And while many Board members will use social media in their own personal lives they may well be naïve about the implications for business.

There are a number of implications that relate to corporate governance. At the simplest level it is easy to disclose financial information inappropriately through social media. Even a social media post along the lines of "Board meeting: didn't we do well!" could fall foul of the regulators.

In the USA, the SEC has extensive and sensible guidelines for social media. In the UK the FCA says that the old FSA guidelines still stand and that these guidelines are platform agnostic. These include somewhat vague statements like "Twitter... may be insufficient to provide balanced & sufficient information" which don't address the difference between "static" content like website articles and "interactive" content like forums and online chat.

At this stage Boards in the UK probably need to second guess what might upset regulators in the future and play it safe.

The Board also has a responsibility to ensure appropriate processes are implemented and managed properly by ensuring:

- social media management and training is in place

- security protocols for corporate social media are adequate
- adequate social media records are kept
- advertising standards are complied with

Board members (and indeed other prominent employees) have another responsibility: to ensure that their own personal or professional use of social media is appropriate and secure. There have been a few cases of senior employees having their Twitter accounts hacked. It probably doesn't matter too much if Jamie Oliver's Twitter account is hacked and sends out tweets promoting diet plans. But if the Twitter account of a High Street Bank's Chief Exec was suddenly to send out messages saying the bank was in trouble it could have a massive effect on share price and even cause a run on the bank. No, it hasn't happened yet...

Employees

Employees also represent a very significant source of risk by talking about their business, colleagues or industry inappropriately. The problem is generally caused by naivety about social media and what it is inappropriate to say or do.

This isn't a hard problem to solve. All organisations should have in place a formal social media policy that gives employees guidelines about their use of social media. All too often though there are problems caused by:

- The lack of a formal social media policy

- An insufficient social media policy
- A failure to explain the social media policy (and the sanctions that attach to it) to employees

It is not sufficient to have a few lines about social media in the employee handbook. The social media policy should be a key strategic document, customised for each organisation.

There is a special sort of employee who can also cause problems: marketers. When marketers get it wrong their errors may well, because of the nature of what they are trying to do, be amplified by other marketing channels. Of course there are plenty of excellent marketers with experience of social media. But where social media is left to an ambitious but inexperienced junior then you can expect problems (or at the least, wasted investment) to happen.

Ex-employees can also be a problem as they sometimes still have the "keys" to social media accounts. Access to company email and files on servers are disabled as a standard but if there is a lack of control over who can use corporate social media accounts then all too easily an ex-employee can retain access to them. There is a potential for "revenge" posts if the ex-employee is unhappy; at if they have moved to a competitor company then there is the potential for confidential data to leak out.

The public

Managing the public through social media is a skilled and difficult task. It is

Managing the Risks of Social Media

one that it is almost impossible to get right 100% of the time: there will always be some people who are offended by something.

The skill is in deciding what represents a crisis and what doesn't. Some complaints are probably worth ignoring. Most should be responded to positively and helpfully – after all complaints represent a source of competitive advantage, if acted on appropriately. (They tell you how to improve your service.)

But sometimes you will be faced with a crisis that spreads beyond one or two unhappy customers. This is why preparing for the possibility of a social media crisis is important. You can never know exactly what might happen. But you can make some educated guesses. The CEO might leave unexpectedly. A new product may fail to perform properly. An employee might be caught out lying to a customer... A review of problems that have previously happened in your industry will give you some pointers.

Once you have identified likely problems you can think about how you would want to manage those problems. What initial holding statements would you issue? Who would be your main spokesperson? Who would be in the crisis team and how much freedom of action would they have?

It is important to prepare well. But as well as preparing it is important to practice by setting up a simulated

social media crisis. Having a dry run will test your crisis management system (for instance, does your escalation process work; do people understand the guidelines within which they have to operate?) And it will give people a realistic experience of what it is like to handle a crisis. (It can be very stressful and sometimes personally hurtful so giving people some experience of what it is like is invaluable.)

Managing social media risks

Social media risks are like any risks. While you can't prepare for every eventuality, a rigorous and structured approach will minimise the likelihood of major disaster and enable most difficulties to be managed effectively.

■ **Audit:** The first thing to do is to **audit your risk profile** and create a comprehensive register of the risks that apply across the whole of your organisation, and proposals for mitigating those risks

■ **Listen:** Next you need to **implement appropriate "social listening" tools** so that you are aware of any relevant social media activity that might represent a risk. The chances are that your marketing department may already be using a listening tool but this needs to be rolled out across your organisation with a single person responsible for identifying problems and notifying the appropriate people

■ **Educate:** Then you will need to **ensure you have a sufficient social media policy** in place; importantly employees (most especially senior employees) will need to be trained in its use and made aware of sanctions for failing to use it

■ **Manage:** You will need to **manage your social media risk activities**; monitoring them to judge whether they are being followed and whether they are effective

■ **Archive:** Most organisations, but especially those in regulated industries, will need to **archive all social media conversations** so that there is a sufficient record of them should that be needed

■ **Prepare:** And you will need to **prepare to meet and manage problems** by creating temporary holding statements, generic responses, guidelines for managing a crisis, and practising your actions

None of this is particularly difficult. But it does take attention to detail as well as a willingness to take these risks seriously. It is unlikely that the worst will happen: but it is very likely that some of the risks you identify will come to pass and without due preparation their effects will be far worse than need have been the case.

The author invites your comments via email to JK@riskrewardlimited.com

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Star Trek Banking... when disaster strikes!

Peter Hughes is a Chartered Accountant, a former banker with JPMorgan Chase and a Visiting Fellow at the Leeds University Business School where he leads research into the convergence of risk and accounting systems. In his article he uses a Star Trek metaphor to illustrate the flaws in conventional risk and accounting systems and the need for a new branch of accounting 'Risk Accounting'. More information on risk accounting is available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2165034

Imagine the US Starship Enterprise flying through space boldly going where no man has gone before. No journey is ever uneventful. Star Trek addicts or 'Trekkies' are all too familiar with scenes of the spaceship suddenly encountering unexpected attacks emanating from alien spaceships or violent atmospheric storms with the crew being helplessly thrown around the bridge. When the crew has made it back to their customary positions the captain demands the inevitable damage assessment. Once that assessment is complete and repairs commissioned attention turns to the spaceship's protective systems. Did the ship's force field and deflectors function as expected and were they effective in limiting impact? Then the captain asks the all-important question... why wasn't there an early warning of the impending disaster?

It's rather like banking

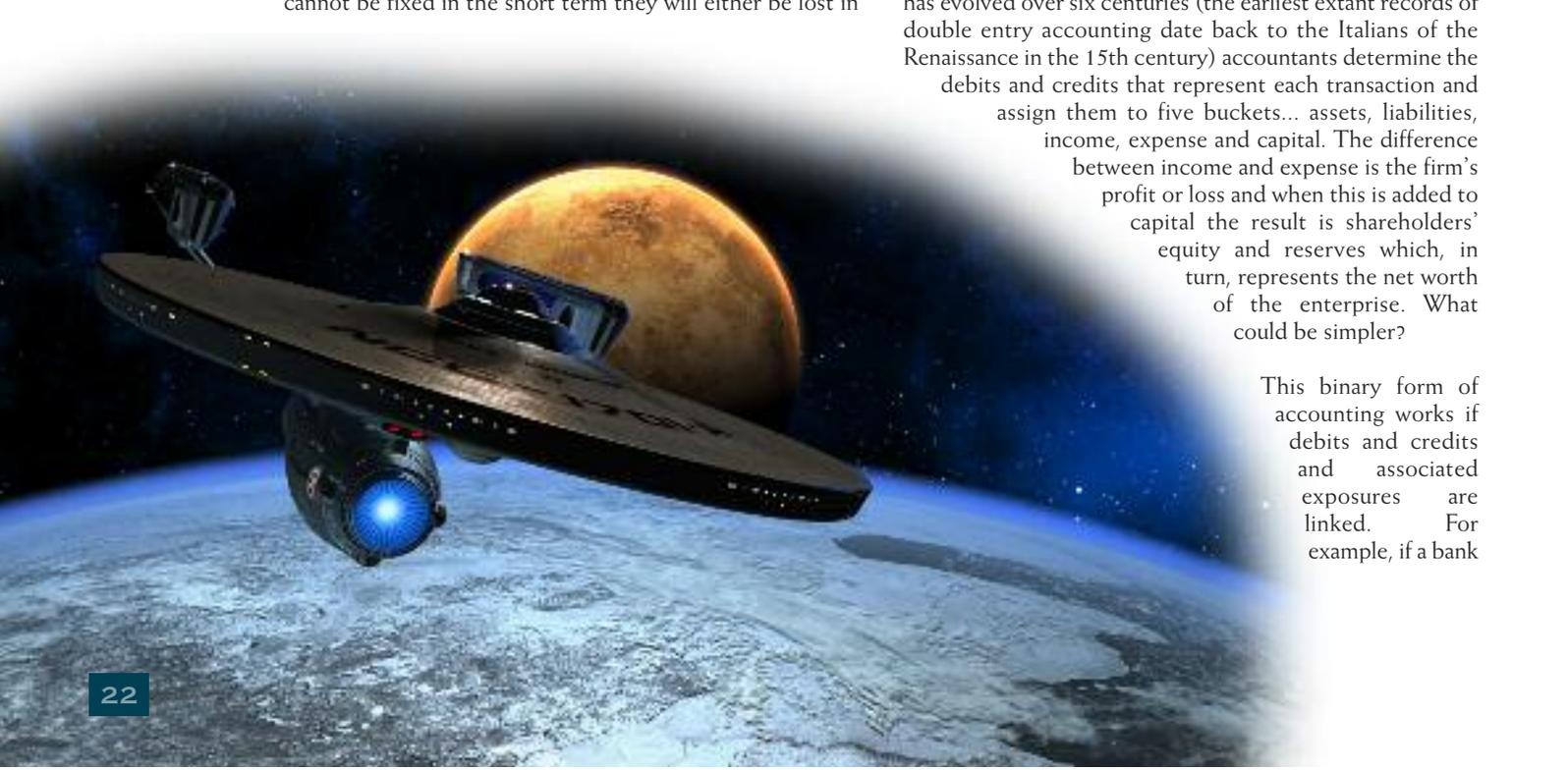
Now imagine a Star Trek episode where, after hitting massive turbulence for whatever reason, the spaceship's steering mechanism fails and the chief engineer has no idea how to fix it. The captain and crew are now faced with a desperate situation. Assuming the steering mechanism cannot be fixed in the short term they will either be lost in

space forever or the spaceship may at some point encounter something that its protective force field and deflectors will not be equal to resulting in its destruction. Either way, they are all doomed.

Also like banking. What? Is the global banking system really doomed?

In our Starship Enterprise metaphor, the steering mechanism that failed is accounting. One of the primary purposes of accounting is to present the financial condition of an operating entity at a given point in time so that the board and senior management can monitor progress against strategic objectives and make informed decisions with the aim of enhancing shareholder value. Accounting began to show signs of real stress in the mid-1990s with the advent and subsequent accelerated growth of the derivative. Up to that point the effectiveness of accounting was in its simplicity... a binary transaction recording mechanism comprised of debits and credits. Following a process that has evolved over six centuries (the earliest extant records of double entry accounting date back to the Italians of the Renaissance in the 15th century) accountants determine the debits and credits that represent each transaction and assign them to five buckets... assets, liabilities, income, expense and capital. The difference between income and expense is the firm's profit or loss and when this is added to capital the result is shareholders' equity and reserves which, in turn, represents the net worth of the enterprise. What could be simpler?

This binary form of accounting works if debits and credits and associated exposures are linked. For example, if a bank



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disburses a loan the debit to the loan account also represents the bank's exposure to the obligor. But if a derivative - let's say a credit default swap - is introduced the amount of economic exposure is delinked from the debit. In this situation the accounting debit becomes merely a numeric record of the amount due from the obligor and the associated economic exposure is transformed into an off balance sheet counterparty exposure. If the credit default swap is then placed into a trading account the counterparty credit exposure is compounded by market risk.

That's a lot for a six centuries old binary recording mechanism to handle. And the truth is, it can't. Indeed, the now rather lame and struggling process of accounting seems only capable of producing audited financial statements that are downright misleading. How can we conclude otherwise when we think back to the financial crisis and all those banks that reported 'healthy' profits followed by a binge-fest of profit distributions in the form of dividends, discretionary bonuses and share buy-backs only to become, months later, the object of taxpayer bail-outs, nationalisations, failures and forced acquisitions? The six centuries old steering mechanism is evidently no longer fit-for-purpose.

We did get an early warning of the increasing frailty of accounting and the likely consequences. The following observation was made almost twenty years ago by economics Nobel laureate Professor Robert Merton:

"Determining appropriate relative comparisons of systemic-risk exposure is the prime measurement issue in the short run. In the longer run... financial accounting needs fundamental revisions and a specialized new branch called 'risk accounting' must be created... Exposure or risk accounting is going to be adapted if we are to have effective external financial accounting and regulation. Current accounting practices are focused on valuation, which is inherently a static measure of financial conditions. Focused on exposures, risk accounting is inherently a dynamic measure of financial condition because it indicates how the individual balance-sheet values are likely to change in response to changes in the underlying financial-economic environment."

Let's return to the US Starship Enterprise with its failed steering mechanism. Super brain Mister Spock has an idea which he is putting to Captain Kirk. He thinks he can figure out a mathematical model that will predict the worst attack the spaceship is likely to suffer as it continues its uncontrolled journey through space. He argues that not only has he stored data relative to the Starship Enterprise's own journeys, but through the United Federation of Planets he also has access to historic data from all journeys undertaken by its members through all known galaxies and it is not unreasonable to assume that, using this data, the model and its outputs will still be valid should they enter new galaxies. Spock's proposition is that all that needs to be done to guarantee survival is to permanently set the spaceship's force fields and deflectors relative to the calculated worst likely attack. Helpfully, Mister Spock adds that his idea comes from a technique developed by 21st century bankers to protect themselves from financial disaster. Captain Kirk

declares himself not entirely comfortable with the plan but, with no steering mechanism, it seems to be the only option. His intuition is that there must be something out there somewhere, the like of which they've never seen before, that they will be unable to avoid through evasive action and it will wipe them out. It's merely a question of when that will happen... days from now, months, years, decades... who knows.

The global financial industry must fix its steering mechanism. It is delusory to believe that accounting based on fair values is capable of providing a fair view of the financial condition of complex financial institutions if the potential future losses attributable to accumulating risk concentrations are not taken into consideration. Such concentrations have grown exponentially since the 1990s as a consequence of IT and operational consolidation through rapidly advancing technology, the widespread use of complex derivative contracts in increasingly sophisticated forms of risk intermediation, the emergence of complex trading and investment structures and the creation of megabanks through successive mergers and acquisitions. Indeed, risk concentrations have achieved a scale that the global financial system will self-destruct if not managed effectively. It is these conditions that became the breeding ground for the new risk foreseen by Merton 'systemic risk' that ultimately triggered the financial crisis of 2007/8 when we stood on the brink of Armageddon.

Mister Spock's formula-based calibration of the spaceship's defence mechanisms is an important component of risk management but it can't substitute for a fully functioning and dependable steering mechanism which must be fixed urgently so that control over the spaceship can be returned to the crew and its navigation systems.

For the global financial system, adapting accounting to meet Professor Merton's risk accounting vision is probably the greatest banking challenge of our age. After all, it cannot be acceptable to regulated financial institutions that they must divert so much of their resources to the maintenance of multiple versions of the same information so that they are positioned to respond to inconsistent regulatory rules and accounting standards. It cannot be acceptable to users of the global financial system and those that invest in it to be presented with audited financial statements based on accounting standards that do not give recognition to all the risks inherent in the transactions financial institutions accept for processing. It cannot be acceptable to boards and senior executives of financial institutions to be presented with financial reports that reflect diverse versions of economic condition and capital driven by accountants' and risk managers' different perspectives of what constitutes exposure and how it should be reported. It cannot be acceptable to regulators that they are unable to observe the build-up of exposure to risk in the global financial system on a complete, consistent and timely basis.

The position is clear... if we fail to fix the spaceship's steering mechanism we are all doomed!

The author invites your comments via email to JK@riskrewardlimited.com

The Bank for International Settlements and Large Exposures

Global Risk Update Editor in-Chief Dennis Cox looks at some of the seemingly innocuous issues raised by the recently published BCBS284.

BCBS 284 published by the Basel Committee on Banking Supervision (BCBS) in April 2014 addressed the topic of large exposures. This paper does include significant detail regarding how a large exposure should be calculated. As with all regulations promulgated by the Bank for International Settlements (BIS) this paper will still need to be locally implemented.

The Issue that is being Addressed

The BIS state that:

“the Core Principles for Effective Banking Supervision (Core Principle 19) require that local laws and bank regulations set prudent limits on large exposures to a single borrower or a closely related group of borrowers.” But neither the 1991 guidance nor the Core Principles set out how banks should measure and aggregate their exposures to a single counterparty, nor do they explain which factors should be taken into account when considering whether separate legal entities form a group of connected counterparties. This has resulted in a considerable variation of practice across the globe.”

There has been some guidance on the importance of large exposures presented within other papers addressing stress testing and scenario modelling, but there is no doubt that some of the issues have not been completely addressed. The question is which are dealt with here and in addition which are dealt with effectively.

In making the case for the requirement for this paper, the BIS state that a:

“large exposures framework complements the Committee’s risk-based capital standard because the latter is not designed specifically to protect banks from large losses resulting from the sudden default of a single counterparty. In particular, the minimum capital requirements (Pillar 1) of the Basel risk-based capital framework implicitly assume that a bank holds infinitely granular portfolios, ie no form of concentration risk is considered in calculating capital requirements. Contrary to this assumption, idiosyncratic risk due to large exposures to

individual counterparties may be present in banks’ portfolios.

Although a supervisory review process (Pillar 2) concentration risk adjustment could be made to mitigate this risk, these adjustments are neither harmonised across jurisdictions, nor designed to protect a bank against very large losses from a single counterparty default. For this reason, the Committee has concluded that the existing risk-based capital framework is not sufficient to fully mitigate the microprudential risk from exposures that are large compared to a bank’s capital resources.

That framework needs to be supplemented with a simple large exposures framework that protects banks from traumatic losses caused by the sudden default of an individual counterparty or group of connected counterparties. To serve as a backstop to risk-based capital requirements, the large exposures framework should be designed so that the maximum possible loss a bank could incur if a single counterparty or group of connected counterparties were to suddenly fail would not endanger the bank’s survival as a going concern.”

There are a number of issues that arise from such a framework. Under Basel 2 credit risk is calibrated at a 99.9% confidence on a one year value at risk (VaR). This was intended to deal with 999 out of 1,000 losses which would surely include the sudden default on a single counterparty regardless of size. To suggest, as the preamble to this paper appears to do, that such a loss is not caught within that calibration is taking loss expectation out to perhaps a fifth standard deviation, which is actually a little radical.

As we know there is no concentration risk calibration in the Basel 2 credit risk calculation and it has been relegated to a Pillar 2 charge. Indeed this is a significant element of the Pillar 2 charge implemented in many countries. There is also the stress

testing framework and the recovery and resolution planning framework to supplement work in these areas. Clearly anything that adds to understanding is logical, but it must be clearly designed to ensure that it does not duplicate other extant rules and regulations. If a single counterparty failure were to endanger the survival of a firm it would of course have been addressed in stress testing, the living will and the recovery and resolution plan.

What Concentration Risk is Being Addressed?

The large exposure paper does significantly restrict itself in what it is seeking to achieve and in many ways I consider this to be unhelpful. They state that:

“The Committee recognises that the risk from large exposures to single counterparties or groups of connected counterparties is not the only type of concentration risk that could undermine a bank’s resilience. Other types include both sectoral and geographical concentrations of asset exposures, reliance on concentrated funding sources, and also a significant net short position in securities, because the bank may incur severe losses if the price of these securities increases. The Committee has decided to focus this framework on losses incurred due to default of a single counterparty or a group of connected counterparties and not to take into account any other type of concentration risk. Similarly, intragroup exposures have not been included in the scope of this framework, although they could be considered as another source of concentration risk that might potentially endanger banks’ survival.”

As we shall see when looking at a few of the requirements there is a basic illogicality to this which undermines the rationale for this paper. If a single counterparty is to fail it fails for a reason. This reason could be complete incompetence by the management team or some other form of own goal, but in such cases the business is generally sound and continues albeit under different management. Generally in such cases the creditors do not receive a haircut

The Bank for International Settlements and Large Exposures

and business continues as usual.

What is more problematic is when there is a change in an industry or an economic reality that starts to question business models or undermines existing products. In such cases a failure of a single firm becomes the first of a series of corporate failures. Recently this has been clear in the High Street where there has been the failure of a number of prominent firms due to changing demographics and ways of working.

In such cases it is an economic issue which causes the failure and a true loss also is incurred, but the loss is of course more than the failure of the single firm. A blighted High Street causes all firms in the High Street to suffer – the loss of the anchor tenants is often key to the on going success. Accordingly the concentration is not aligned just to the single firm, but is broader. Secondly the suppliers to the firm also suffer, as do their employees and the firms the employee use. This is the contagion effect of the failure. So the question is what is the point in producing new rules for the single exposure which to an significant extent already sit within other rules and expectations?

As we shall see there has been some attempt to deal with some of these matters, but the extent of coverage is perhaps questionable.

What is a Large Exposure?

In this paper this is defined as:

The sum of all exposure values of a bank to a counterparty or to a group of connected counterparties, if it is equal to or above 10% of the bank's eligible capital base.

The requirement is that international active banks must report to their supervisor the exposure values before and after application of credit risk mitigation techniques. Banks must report to the supervisor:

- (i) all exposures with values measured as equal to or above 10% of the bank's eligible capital (ie meeting the definition of a large exposure);
- (ii) all other exposures with values measured as specified without

- the effect of credit risk mitigation being taken into account equal to or above 10% of the bank's eligible capital;
- (iii) all the exempted exposures with values equal to or above 10% of the bank's eligible capital;
- (iv) their largest 20 exposures to counterparties measured and included in the scope of application, irrespective of the values of these exposures relative to the bank's eligible capital base.

They then set a minimum large exposure by requiring that the sum of all the exposure values of a bank to a single counterparty or to a group of connected counterparties must not be higher than 25% of the bank's available eligible capital base at all times. However, this figure is set at 15% for a G-SIB's exposures to another G-SIB.

Connected Counterparty

What is a connected counterparty? This is also addressed in the paper, as follows:

The importance of connectedness is recognised by the BIS who state that:

"In some cases, a bank may have exposures to a group of counterparties with specific relationships or dependencies such that, were one of the counterparties to fail, all of the counterparties would very likely fail. A group of this sort, referred to in this framework as a group of connected counterparties, must be treated as a single counterparty. In this case, the sum of the bank's exposures to all the individual entities included within a group of connected counterparties is subject to the large exposure limit and to the regulatory reporting requirements as specified above."

This is of course exactly what you would expect. However with this style of regulation the details can be complex to deal with as we shall see. Two tests are initially provided to identify deemed connectivity. The standard states that:

"Two or more natural or legal persons shall be deemed a group of connected counterparties if at least one of the following criteria is satisfied."

- (a) *Control relationship: one of the counterparties, directly or indirectly, has control over the other(s).*
- (b) *Economic interdependence: if one of the*

counterparties were to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter funding or repayment difficulties."

Direct control is deemed to exist if 50% of the voting rights are held, so Royal Bank of Scotland would be deemed to be controlled by the UK government under these rules. In other areas (significant influence, appointment of directors etc) the control rules broadly follow the existing IFRS accounting rules.

The inclusion of indirect control here is interesting and does place some additional obligations on firms. Given the nature of the reporting systems within many banks indirect controllers are identified in single entities but rarely across multiple entities. Accordingly there is probably a data collection requirement arising from the implementation of these rules.

Going back to the High Street example identified above. If an anchor tenant in a High Street has financial difficulties would this be sufficient to require the economic dependence test to be applied? The answer appears to be that this is not the case.

In establishing connectedness based on economic interdependence, the BIS require that banks must consider, at a minimum, the following qualitative criteria:

- Where 50% or more of one counterparty's gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty (eg the owner of a residential/commercial property and the tenant who pays a significant part of the rent);
- Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs;
- Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers;
- When the expected source of funds

Negotiation Risk

to repay each loan one counterparty makes to another is the same and the counterparty does not have another source of income from which the loan may be fully repaid;

- Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities;
- Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s);
- When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found -in this case, the funding problems of one counterparty are likely to spread to another due to a one-way or two-way dependence on the same main funding source.

Now at last the true difficulty of these rules becomes clear. We all know what the BIS is trying to do, but in attempting to catch everything matters become quite complex. If we take a car showroom, for example, the product they sell could be totally dependent on the single car distributor. Does this mean that they are "derived" from transactions with the other counterparty? The examples provided do not make this clear. Accordingly under these rules my suspicion is that you are not required to link every car dealership with the car producer.

The loss of the single major customer is significant though. If the car manufacturer fails then many of their suppliers will fail. Do you have that data available? I would suspect not in a form that enables it to easily be obtained, so again a key element of data collection. But what about 50%? As a company if I lose a customer that accounts for 25% of my business then I would expect to have some problems. If I have lost 40% of my turnover, the question is whether or not I would survive. If I am running a business where my costs are essentially fixed but my income is variable the level of loss leading to failure is likely to be well below the 50%. However

on the other side there is a contrarian argument.

If you have a major customer single it is often the case that the supplier is unable to supply their competitors. If the customer fails the market available to the other potential customers grow and they potentially also require supply, In such cases the supplier may not experience the full loss value of the customer collapse and may be able to replace one customer with another. This is not considered in these rules.

Given that supplier and customer information is not included in annual statutory accounts and instead is recorded in credit applications by relationship managers with little if any verification the concern is that this neglected area may become of greater significance. Then what of the secondary effects? If I lose my job then my cleaner and gardener lose their jobs. Are we linking the corporate failure to the personal failure and the impact on collateral values? The answer is not yet.

Interbank Exposures

We are not going to discuss the measurement and mitigation issues here, so reference should be made to the paper itself in this regard. Instead I am surprised by the following comment in the paper:

"To avoid disturbing the payment and settlement processes, intraday interbank exposures are not subject to the large exposures framework, either for reporting purposes or for application of the large exposure limit. In stressed circumstances, supervisors may have to accept a breach of an interbank limit ex post, in order to help ensure stability in the interbank market."

This is of course not sensible under any level. Banks are already required to have limits for such issues and there are separate papers produced on intraday monitoring. The exclude it here when probably it is most important is in my opinion naive. The requirement should have been to include the limit within the connected exposure; but instead they have left it out. To say that interbank limits can be moved under stress is also in my opinion running against everything that has been achieved in developing stress testing.

Increasing connectivity under stress increases the risk of contagion. That is one of the key lessons from the recent crisis. Accordingly my hope is that regulators do take account of the suggestion made here and do not accept a breach of interbank limits under such a circumstance.

Other Matters

This paper is due to be implemented 1 January 2019 so there is time to sort out a few matters. For example Central counterparty exposures are not currently to be included but will be addressed in due course.

There is a long section looking at what are termed additional risks which refer to where a third party provider supports perhaps technically a range of products. This seems to be aimed at securitisation linkage potentially extending connectivity.

The scope could be broad as stated as follows:

"Banks must identify third parties that may constitute an additional risk factor inherent in a structure itself rather than in the underlying assets. Such a third party could be a risk factor for more than one structure that a bank invests in. Examples of roles played by third parties include originator, fund manager, liquidity provider and credit protection provider."

Again this is another data requirement for banks to deal with since this is another area where data is not currently collated in the way envisaged.

Conclusion

As you can see this appears at first sight to be an innocuous paper. If you just looked at the heading you might have thought it was just changing some form of reporting; but as you can see there is much to do. The connectivity rules are changing and broadening and this does mean that more information is likely to be required than was previously the case. Worse than that is perhaps that the data that is recorded will not have currently been routinely verified by the bank and with new regulatory impetus I would suggest that greater care may be required in such areas.

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