GLOBAL riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

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2017 Economic Predictions

Also in this issue

- Negotiation Risk
- The Threat to Banks
- When They Call You Who Are You Gonna Call
- Turkey: The Impact of Fitch's Downgrade to BB+

2017: Economic Predictions

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At last we are here, the actual year of living dangerously. 2016 was an unusual year where we had a variety of national elections each of which has perhaps a rather unanticipated outcome. There will be perhaps others next year. Why has this happened and what that will mean for 2017?

In the past few months the U.K. had the Brexit vote whereby a small majority the people rose up and delivered what was an unexpected result to both the government and the financial markets.

The UK wanted to leave Europe. It took the view that an unelected elite in Brussels and Strasbourg were ruling Europe in a way the UK could not understand. Of course at present we do not have Brexit or even the start of Brexit. Even if we start the process we need parliamentary approval and then the approval of all the European Union Member states. We will most likely achieve this, but will Brexit be the main issue on the UK government's agenda for 2017? Probably not.

Our view is that when everything settles down 2 years from now in 2019 Brexit and non-Brexit UK will look pretty much the same. There will be a few deckchairs shuffled around and perhaps the government will save a little money, but actually the UK will look much the same.

Also in the UK there was a leadership election(s) for the labour party with
Jeremy Corbyn being elected with a little help from his friends. Again he was not the centralist candidate and had not been expected to win. Multiple, socially diverse voices rose up and delivered what was an unexpected result to the markets.

These voices took the view that an elite were ruling the labour party in a way they could not understand. They voters thought of themselves as the rank and file. They were the Labour party. They needed a leader that was more like them.

But in fact Jeremy Corbyn is not like them. He is a career politician who has been on the edge of the Labour party for years. In 2019 when this all settles down the Labour party will go back to being much the same. Again a few deckchairs will have been moved around but nothing will really change.

The USA presidential election produced a new President elected with a little help from his friends. Again he was not the centralist candidate and had not been expected to win. Again we found that multiple, diverse voices rose up and delivered what was an unexpected result to the ruling establishment and financial markets. Again people took the view that an elite were ruling the country and that they 'wanted their country back.' They wanted change and the new President campaigned on a change platform.

But he isn't one of them and It is not expected that he will deliver change. In 2019 when it all settles down the USA will go back to being much the same and again after some deckchairs will have been moved around.

Why in 2019? Because we believe that is the beginning of the next long term economic trend (2017 and 2018 being the end of the period after the last trend or the period before the start of the next trend, the period of maximum uncertainty. These next 2 years are the period of living dangerously.)

We foresee Increasingly key roles in both government and the international business community will be held by people without the background or skills to react rationally to extreme changing circumstances.

In these upcoming two years we are entering the period of rising interest rates, a massively indebted global community, fixed rate housing loans in the USA, increased global unrest and with banking regulations designed for a different environment. Not a good scenario.

So here are our predictions for 2017 and 2018:

(1) Rising Interest Rates

There are two possible scenarios. Either interest rates will rise slowly or they will rise quickly. If there is inappropriate intervention they will rise more quickly then they would have done. Our expectation is that LIBOR interest rates will increase by 175 basis points in 2017 and 250 basis points in 2018. However since at an increase in interest rates of 125 basis points the debt crisis in the USA will become unsustainable we will have to see if the preventative action required will be taken on a timely basis. Our concern is that actions will not be executed quickly and we could easily see a spike in interest rates.

We are concerned that the US housing loan market is dominated by fixed rate loans. If interest rates rise the result will have perverse outcomes: for example at this point nobody repays their loans early any more. They just hold them and continue to repay them if they can. If they try to refinance and move to a new loan it would be at a higher rate so better to not change lenders. This also means the housing market slows down and we can see both increased unemployment and unfilled job vacancies. Sounding familiar? This is the market we believe we are moving into.

For the US banks and quasi governmental bodies the problem is obvious. If you are giving out housing loans at around 3.5% you cannot afford an increase in funding of 125 basis points. It renders the industry unprofitable and unsustainable. So the stress interest rates for LIBOR are 7% in 2017 and 13% in 2018.

(2) Fixed Income Bonds

In an interest rising environment you can only issue bonds where the price is maintained due to the redemption value. That means an average maturity of no longer than 18 months. The problem is that the market is used to longer dated paper which will disappear because there is never a right time to buy it. It will always be better value tomorrow. Of course when you are talking about debt issuance the key issuers are governments and it is not in our opinion possible to fund the global debts with short dated notes. That would suggest we will get defaults but probably not in 2017, or at any rate not early in 2017.

However in 2018 we do expect both defaults and extensions to existing paper issuance. Neither year will be good for fixed income bonds.

(3) Gold

As a consequence we do expect this to be a market where certain commodities will be seen as a safe haven from the world's financial turmoil. We would expect gold to strengthen by 10% in 2017 and this trend to continue into 2018.

(4) Oil

The oil price has never been harder to predict. 2017 and 2018 will not be years where there is global growth so no increase in energy usage can be anticipated. At the same time a reduction in energy usage through changing power production will also make a small difference, but this is only at the peripheries. They key issue will be the continued global unrest and whether OPEC can manage its members effectively. In combination we expect 2017 to be a year of benign decline for oil ending the year around $43 and probably not much different in 2018.

(5) Stock Markets

This is a time when defensive stocks will perform well again. The stock market will rise primarily due to the lack of a real alternative for most people. We expect the FTSE to increase by 9% in 2017 an

The outlook is bumpy and inflation will start to kick in during 2017. With a fair wind and competent people the results will not be too bad. However this is the period of perverse outcomes and we do have other key elections upcoming in Europe.

Risk Reward Limited has provided high-quality, service excellent, good value guidance to banks, insurers and asset managers worldwide for more than 15 years and can provide you with the help you need to navigate these difficult waters. Contact our London or Miami offices to arrange a preliminary consultation.

The author invites comments via email to
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The Threat to Banks

Viewpoint from the Editor of Global Risk Update.

News flash: Banks are evil and full of evil people. They need to be punished and we need to make sure that the problems of the past never recur. The past in this case is the crisis of 2007 where so-called 'casino bankers' nearly caused the collapse of capitalist society.

That this crisis is so little understood and had more to do with misguided, but well intentioned, regulation has been well documented. The problem is that by misunderstanding the causes of the problem then the solutions implemented are unlikely to be worthwhile.

So what are the some of the threats to banking? And how will banks survive?

(1) Banking Regulation

Banking regulation are not guardians of banks or the banking system. Regulators are essentially unelected officials with enormous power, often from central banks, mainly political appointees, who set the rules. In the USA at least 50% of banking supervision heads at state level are individuals with law degrees with little financial services experience.

What are the success criteria for regulators? They are judged as successful if banks under their jurisdiction do not fail as a consequence of the actions that they have taken. Whether this is good for the global economy or society is actually not their concern. They essentially have a single goal to ensure that if a single institution fails that no other institution will fail. That this makes very little sense is not currently an issue addressed by industry or society through social media.

(2) Customer Expectations

Recently banks had numerous branches to show that they were a big bank. Lots of branches suggested success.

Customers went into branches to deposit funds, arrange loans and make payments. These days have gone forever. Now there are very few reasons to go to a bank and even if you do retail customers are increasingly confronted with a machine and a person to explain how the machine works.

Most retail customers do not want to visit the branch unless they have to. Corporate bankers come to their customers.

Payments are being made electronically, and do the banks really want deposits? We will come to this again later.

As customers increasingly resort to on-line services there is a change in customer loyalty. Many of you will still retain your first bank account. In future this will not be the case and customers will increasingly be receptive to marketing approaches from new businesses. If retail customers are doing their banking on-line then they expect it to be relatively cheap, so the banks' ability to charge is reduced.

As customers expect more for less their profitability to the bank is significantly reduced. Activity based costing, which is essentially recommended by the new regulation, becomes a must for banks. They need to identify which products that they sell are profitable and indeed which customers remain profitable. It is perhaps a sad fact that customers that visit the branches are rarely profitable; indeed they are often the customers that have not fully embraced the opportunities that internet and mobile technology provides.

This poses society with a problem. As retail bank branches close many towns will not have any branches at all leaving customers who do require those branch services - including the elderly and disabled - disenfranchised. But can banks really be expected to continue to provide loss-making services?

The dilemma is that society's general view is that banks are bad and need to be punished, not that they provide essential services to communities.

(3) Changing Competition

The role of the bank used to be to cycle money within the financial system. They took in deposits from the public and used these funds to provide facilities to other parties. Housing loans, which we will come to later, were at the heart of this activity. The income of the bank was generally related to their ability to raise a decent margin over their cost of funds (the deposits) in the rate that they charge to their customers.

The best bank customers were never particularly profitable. They were able to always get preferential rates and lower charges than less well-off customers. Banks make their money from charging relatively higher rates to customers who have limited ability to go anywhere else. The better rated customer can go anywhere whereas the lower rated customer is often stuck with the bank it is with.
In the 1970s the maintenance of an extensive branch network was both expensive and formed a barrier to new entrants. Now that so much banking is undertaken on the internet these barriers have essentially gone and it is easier for parts of the business to be eroded. Of course it is deposit taking that determines a firm is licensed as a bank. Many institutions that lent money were never banks, indeed anyone lending out their own money did not require a banking license, although another form of registration might be required. The new market lending entrants will not particularly want to be deposit takers, they will just want a low cost of funding.

New lending firms want to take the profitable business that traditionally has been undertaken by the banks, which is lending to what might be termed second and third quartile customers. Peer to peer lending is one such opportunity but it is not alone. Increasingly as deposit rates are low or lag inflation companies with funds are seeking ways of achieving a return. They will do this in part by essentially banking their supply chain. The benefits of certainty that this provides them with and the increased return that they receive makes this all worthwhile and the regulatory arbitrage that is biased against the banks makes it profitable.

So banks have customers that are less loyal and expect more for less while at the same time new entrants are arriving to take their customers..

(4) The Changing Regulations

For banks it does not matter where you turn, the regulations are changing dramatically. (And not just banks: other parts of the financial services industry are also being hit by these changes with MiFID, MAD, AIFMD and EMIR being just a few of the changes coming through.)
The impact of Basel 3 (or Dodd-Frank for the USA) on banking has been draconian.

We see that there is a significant misunderstanding which is at the heart of this new regulation.

The regulators are wedded to the idea that banks need ever increasing levels of capital and liquidity sufficient to ensure that were they to fail that no other firm would be critically damaged, what is referred to as contagion. They need to have sufficient capital and liquidity to deal with extreme stress, events that are extremely unlikely to occur.

Maintaining excessive capital and liquidity is expensive. The returns on these assets is poor and essentially they cannot really be used. Do you remember the idea of insurance was that the losses of the few were picked up by the many? This simple opportunity for risk sharing is now lost forever in the banking industry.

Each bank needs to keep its own capital and liquidity sufficient to address a stress event which is unlikely to occur.

This is manifestly inefficient. By causing banks to tie up excessive capital and liquidity the regulators are both removing these assets from the money supply and making it more expensive for the banks to lend out their funds. This then impacts the economy at large restricting the funds available while increasing their price. This plays into the hands of the new entrants who may not have all of these requirements to comply with.

Current banking regulation actually hurts society, increases unemployment and reduces economic growth. Clearly the level of capital and liquidity that a bank maintains should be sufficient for the day to day running of the bank and to cover moderate stress. In the past extreme stress was addressed by the lender of last resort, the Central Bank, but that is no

longer the case. With the Central Banks no longer fulfilling that role, and no replacement mechanism created for all the banks to pay into, the regulators have enforced a regime on all the banks which ensures that they are unable to meet the key obligations of their lending and cycling role.

(5) Central Counterparties

Amongst the biggest mistakes that regulators have made is the dislocation of the derivatives.
Why has this happened?

The financial crisis was misunderstood, thought to be caused by weaknesses in the regulation and transparency of derivatives so something had to be done. But was it? The so-called derivatives that perhaps were at the heart of the problem were what are termed securitised assets. An important asset class these are a pool of facilities, such as housing loans, which are packaged and turned into bonds. Interestingly the regulations governing these assets have barely changed since the rules were there already although not enforced.

New regulation was the answer, but what was the problem?

The decision was taken to move as much of the derivatives market to central counterparties as possible. Either the instrument should be conducted on an exchange with daily mark to market margin or the margin should be posted to such an exchange. This is now in place and has increased the risk that it was intended to reduce.

In the past such transactions were conducted on the basis of robust legal documentation developed by the International Swap Dealers Association (ISDA). Such instruments actually assisted during the crisis in transferring risk throughout the system. They were not the cause of the crisis, rather they were the solution. In the new environment with margin being placed their liquidity has disappeared. Bid offer spreads have widened. Risk is now concentrated in central counterparties which are applying margin rules which are actually lower than the risk requirements of firms. They are not providing these bodies with sufficient assets to withstand extreme stress since the level of margin that would be required would result in disappearance of all such instruments. This actually means that far from reducing the level of global risk, the risk has actually increased. We believe that the next crisis is likely to be caused by a failure of a central counterparty and the derivatives market will not be able to help.

(6) Interest rates

There also appears to be a lot of confusion regarding the purpose and impact of interest rates. Interest rates have become artificially low due to government action. At such rates the banks find it harder to make a profit. Increasing rates provides banks with the ability to raise rates on floating rate loans, but of course not fixed rate loans which are the cornerstone of the US economy.

It is always important to remember that floating rate notes and bonds do not float; rather they step in arrears based on a reference value. They do not float due to an increase in capital or liquidity requirements unless this is specified in the customer agreement.

The pressure is to increase interest rates in the US and with regret the rest of the world will follow. We have a higher level of government borrowing globally than has ever been the case before. Indeed the numbers are staggering. The problem with raising interest rates is that at some stage the investors recognise that fixed rate bonds are poor value unless their value is anchored by a relatively short redemption period. The idea of trying to fund the US economy based upon three-, six- and nine-month bonds is really rather challenging. As interest rates rise the expectation is that sovereigns and municipals will default causing all sorts of problems.

That the regulations that the banks have to comply with are designed for a market where interest rates are declining is only part of the problem.

We are entering a difficult part of the economic cycle with globally leverage at heightened levels.

Bringing it together

So banks will need to deal with the cost of regulation, higher capital and liquidity, greater competition and a market which is not conducive to being profitable. None of this is easy. With IFRS 9 now requiring even more provisions for the banks perhaps we have reached the point where banks will start to wonder if their business model still works.

As a continuing trend we expect many more banks to merge since the next crisis rather than being a 'too big to fail' crisis will actually be a 'too small to succeed' crisis. Banks need to become much more efficient and be clear how they will make money in this new environment which is likely to last for the coming 20 years.

At Risk Reward our consultants have lived through these stressful times working in both higher and lower risk markets. We can assist your teams in dealing with the challenges that the markets present. A stressful market does not mean that all firms fail. Good firms that are able to plan for the future will pull ahead if the competition and thrive. Contact our independent banking and risk experts in London or Miami to arrange a preliminary consultation to see how we can help you best.

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Negotiation Risk

Rohan Badenhorst (CIMA) is a financial services professional and thought leader specialising in 'the big picture', systemic and structural relationships within and among financial organisations. Risk takes many shapes and forms. Being able to navigate the route map and understand the landscape of negotiating transactions, deals or commercial contracts will help us envision the expected outcomes more clearly. In the first of a two part series of articles, Rohan Badenhorst, CGMA, takes us through the various levels of appreciating the nuances and reality of Negotiation Risk

Have you ever experienced the sinking feeling that you have been outfoxed in a negotiation scenario? Of course you have. We all have at some point or another come across someone, somewhere, somehow who was just plain better than ourselves at negotiations. Negotiation certainly is a skill we can learn and nurture our entire lives. At the core of our everyday existence, we have to be negotiators at heart. Negotiations have many facets and layers to them and bearing in mind Pareto's efficiency and golden rule of the 80 / 20 principle, certainly 80% of us are continually stuck on Level 1. We see five distinct and different levels of negotiation.

Level One – The TRANSACTION-based negotiation

This is the level where at least the majority, if not 80% of individuals find themselves. Effectively people with a transaction based approach don't really enjoy or relish the cut and thrust of any good negotiation (or negotiation process). Mostly flung into situations where you have to let go of your safety net and comfort blanket in order to get the best 'deal' available to the organisation or party you are negotiating for. We call these situations the 'size of the slice' negotiations. Effectively the zero sum game negotiations where each party is negotiating in order to extract the largest chunk of an already carved up pie.

Level Two – The RELATIONSHIP-based negotiation

This is the level where we really start differentiating ourselves from the 'crowd'. We believe that only 16% of negotiators find themselves 'comfortable' at this level. Basically these are skills individuals who understand that there actually is a 'pie' out there and that the main focus is on getting a large a slice as possible of this pie. We call them the win-win negotiators.

Level Three – The VALUE-based negotiators

This is where we believe only 2.5% of the really skilled negotiators find themselves on the continuum. Value- based negotiators actually understand and appreciate the fact that the size of the eventual pie has not yet been determined. They seek the 'hidden value' in the negotiation and possession and design the deal in such a fashion that both or all interested parties secure positions that are both advantageous, yet can become even more so via cooperation and collaboration. Quite a powerful place to be.

However, we pause at this point to reflect on the basic premise of the three levels we have explored so far. Astute observers might have noticed that all three levels are based on what we refer to as 'extractive' tactics and strategies. The main tasks of the negotiator is to extract the maximum value from the deal for themselves or their related parties, the organisation or group of individuals they represent.

Moving on to levels four and five requires a complete step change and mental adjustment only around 0.5% [or the rest] can make.

These negotiators are so rare and valuable that to come across the few out there really is a privilege and a special situation to savour. There rewards and returns are exponential, compared to the 99.5% transaction negotiators.

Level Four – OPPORTUNITY-based negotiators

Opportunity-based negotiators have at their core being a desire to grow and develop markets. Sometimes called 'rain-makers' there is a mistaken perceptions that these highly skilled negotiators have the ability to move markets or are market makers. That is true to some extent, however they understand that value in any deal is not about an extraction of the value, but more about the creation of value. This is a fundamental mental step change. Eccentrics these characters may even

be, but once you come across an opportunity based negotiator, you know you have began to meet your match and are dealing with a very special type of negotiator.

Level Five - CRE8(OR)S

Cre8(or)s or rather creative negotiators are so rare that we shall not spend too much time analysing their style and influence on negotiations. Bear in mind that these types really appreciate and rarely actually engage in a negotiation, because they spend so much time designing a deal that most of 'hard' negotiation tactics are delegated to skilled professionals. It is important to understand that these individuals dwell in a completely different 'universe' of negotiations to the rest of the population. This is why only around 0.1% of individuals fall within this category.

Actions

The great opportunity for the vast majority of us mere mortal negotiators dwelling in level 1 is that the only way is up the ladder and that through skills training and practice we can develop the talent necessary to become better negotiators. One of the key ingredients to appreciate is the fact that once you get beyond a transaction based negotiation, and by transaction based negotiation we refer to the 'supermarket' negotiation, because you have to accept the price of the product presented to you, every negotiation has at its core a design element to it. Take some time to think and appreciate the design elements of the negotiation to become a more successful negotiator.

In the next article of this series on Negotiation Risk, we will focus more closely on design elements and risk factors of the relationship and value based negotiation.

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When They Call You Who Are You Gonna Call?

A risk practitioner's guide to Making Good Credit Risk Management Happen by Mary Phibbs

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

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

The Challenge

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

For instance,

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

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

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

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

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

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

You will have to put this into your own words, of course, as you will know what best suits your organization and culture. A hint: you really do have to connect with as many people as possible when you get it out there as they won't hear your message until they know you care, so think big. Having started to paint a picture of where you are headed in broad terms the next step is to work out where you are at present. A great way to do this apart from looking at what documentation, reports internal and external etc you have is to actually ask a good cross- section of your key stakeholders. This will also have the benefit of engaging a wide variety of people into what you are trying to achieve early on. It may include the board and the regulator but don't forget the more junior members of your team and the sales people and/or relationship managers and loan officers who have direct contact with the customers. These people usually have a really good idea of what is going on your organization and it's just that so far maybe no one has thought to ask them. Try and think laterally about the type of data that will be helpful, e.g. if staff engagement data is available a low score will give you a fair indication that the risk culture will be wanting. The same goes for

customer satisfaction surveys. Further, high turnover in credit risk roles could also indicate issues.

Getting Organised

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

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

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

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

1 Strategic

Mission and objectives

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

Strategic Plan

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

Risk Appetite

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

Capital management

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

2 Structure & Framework

Committees

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

Structure

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

Policies

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

3 Process and Portfolio

Approvals & Process

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

Models

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

Data

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

Systems

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

4 People and Capabilities

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

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

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

Don't forget

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

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

The author invites comments via email to
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Turkey: The Impact of Fitch's Downgrade to BB+

From this Edition's Guest Contributor, Mert Berker.

Unfortunately due to the recent geopolitical tensions and economic slowdown Fitch Ratings has downgraded Turkey to BB+ however, maintains long term Turkish lira ratings at investment grade while the Japanese ratings agency JCR still rates Turkish sovereign at investment grade.

And on January 30, 2017 the Istanbul Stock exchange increased by 2.88 percent which means there is still interest from foreign investors in Turkey.

As you may know many larger banks and cooperatives are rated at least investment grade in Turkey and gain the majority of their revenues from their operations outside of Turkey.

We believe that even though there will be slower economic growth over the medium term, interest in Turkey will continue from foreign investors.

You may have also followed recently that UK and Turkey had talks about a possible trade partnership post-Brexit which is also a positive sign as a major advanced economy is still interested in cooperating with Turkey.

Furthermore the ongoing cease-fire talks between Turkey, Iran and Russia regarding the conflict in Syria may bring some stability into the region.

Finally, Morgan Stanley has stated that even though on average it takes about 6.1 years for a country

to get back to investment grade this could happen sooner in Turkey due to the fact that Turkey has stronger growth levels and better performance that its peers in terms of fiscal discipline.

So while Fitch's downgrade makes headlines those in the know continue to value Turkey as growth-led investment grade.

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