

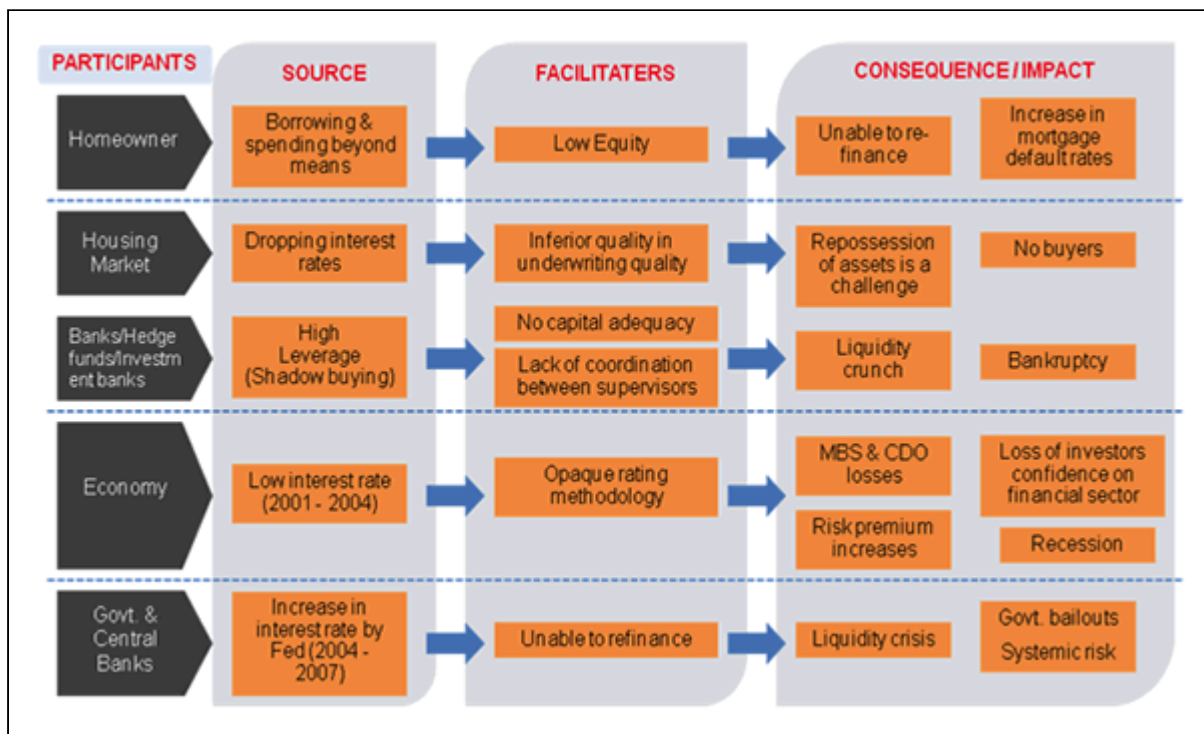
Dealing with the Financial Crisis: Enforce Risk Management

Rosy Stuart, Oracle - 28 Oct 2008

The current financial crisis has highlighted the critical importance of ensuring that a firm's senior managers have a transparent and robust oversight of capital, liquidity and risk management. This article outlines the principles that all institutions should be upholding right now.

Whether we consider recent events from the vantage point of the sub-prime mortgage industry's losses, the proliferation of sophisticated financial products, or the collapse in confidence in investment and commercial banks taking place at the moment, the scale of the crisis is substantial. We all know about the sub-prime crisis and the world as we know it is changing in its aftermath. The entire global economic system is interconnected - what affects one nation touches others. If the troubled country is the US, it reaches everywhere and if the crisis is great enough, the disease may be fatal and human wreckage catastrophic. This is precisely the current dilemma that world leaders and financial experts are currently scrambling to figure out. They are desperate to contain, and not sure what, if anything, can work. The lingering question is: how did this happen and why?

Figure 1: Story of the Sub-prime Mortgage Crisis



Where Did it Start?

The financial crisis that has taken the world by storm over the past 12 months has not dissipated despite efforts by the US government to keep dishing out rescue plans and joint actions with other central banks to inject massive sums of money into the markets. No one seems to be able to tell when the crisis will actually retreat, but one thing is sure: it has displayed the trend of further propagation, as evidenced by the spread of its fallout to financial institutions in Europe calling for similar rescue packages. The root cause, to some extent, reflects the laxity with which the US was regulating the disbursement of sub-prime mortgage loans, as well as the derivatives that evolved from them.

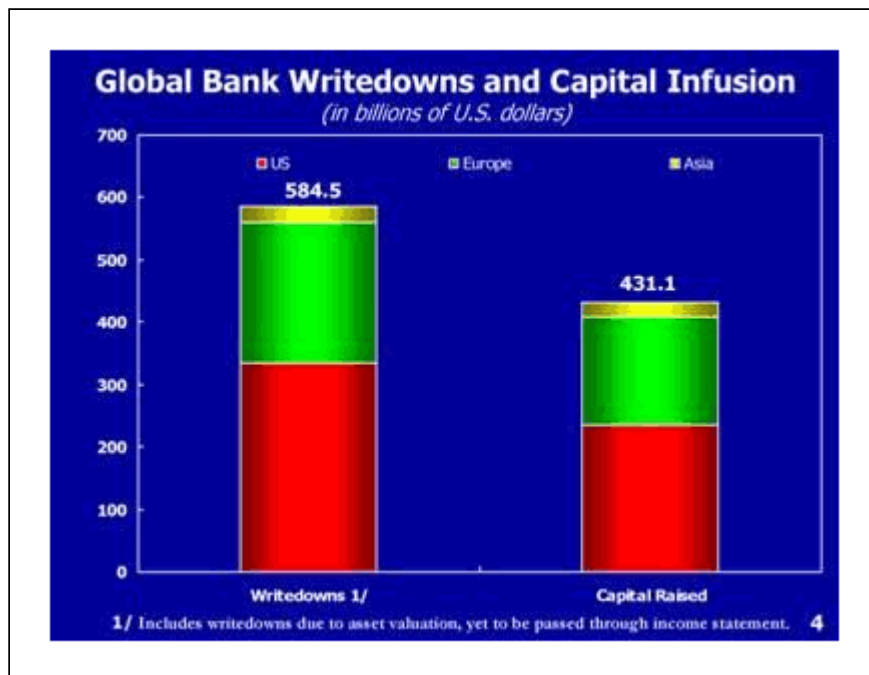
The financial institutions of many countries, in particular developed and emerging economies, were lured in by such derivatives, which explains the wide reach of the latest crisis. As liquidity began to disappear in the asset-backed securities markets, counterparties became increasingly risk averse, making funding extremely difficult to obtain and creating uncertainties about valuation and creditworthiness that persist to

this day.

With Uncle Sam sneezing now, the whole world is poised to catch a cold soon. Although the crisis has erupted in the US, it could bear down on ordinary people like you and me. Having gone through the recent falls, investors should have gained some wisdom now, and they will try to avoid absorbing stocks they are unfamiliar with, let alone commodities that they seldom hear of. More importantly, we must refrain from swiping our cards unnecessarily during this period of economic uncertainty.

The collapses of Lehman and many other financial institutions in the last few weeks have put a great deal of strain on the system. And when you have a system that's already under stress, that strain is hard to take.

Figure 2: Global Bank Writedowns and Capital Infusion



Source: Finfacts Team, 8 October 2008

With financial markets worldwide facing growing turmoil, internationally coherent and decisive policy measures are required to restore confidence in the global financial system. In a report published earlier this month, the IMF says that the losses in the US sub-prime assets and securities will ultimately total US\$1.45 trillion (€1.07 trillion; £828bn), more than 50% above its April 2008 estimate of US\$945bn. The IMF has called for 'a comprehensive set of measures that could arrest the currently destructive process. Failure to do so could usher in a period in which the ongoing deleveraging process becomes increasingly disorderly and costly for the real economy'.

Where do We Stand Now?

The current upheaval in the global financial markets has caused more mayhem in a month than the world has seen in its entire economic history. The financial market turmoil has not yet come to an end. In fact, over the past few weeks, it has intensified yet again. More large financial institutions have failed or had to be taken over by others, while a number of markets have exhibited increased volatility and reduced liquidity. In particular, significant tensions persist in global money markets, where market liquidity is strained and term interest rates are elevated. Meanwhile, volatility has increased in other global financial markets, particularly for equities and commodities.

Central banks have provided liquidity to help to stabilise conditions. In addition, public authorities have announced a number of measures and initiatives to address problems within stressed markets and troubled individual institutions. Nevertheless, international money markets remain under stress. Too much volatility is, to a large extent, a reflection of the urgent need to control investors' 'animal spirits' through the appropriate market and institutional framework.

Strengthening supervision, regulation, risk management, accounting and transparency frameworks are of great importance. Several governments have taken decisive action to address credit concerns and central banks have been co-ordinating action to address liquidity pressures in funding markets. It is extremely important for central banks to strengthen enhanced information sharing and collective monitoring of market

developments. Central banks should take steps to strengthen their capacity to counter problems in the international circulation of liquidity.

The US government has stepped up to bailout financial institutions; bailouts are needed in the short run must be targeted at low-income victims of the sub-prime deals. In the longer term, the solution will require leaders to revamp the financial framework and limit risks, including: better financial information; simplified legal contracts and regulations; expanded markets for managing risks; home equity insurance policies; income-linked home loans; and new measures to protect consumers against hidden inflationary effects.

Renewed Focus on Regulation

It is important to note that market events over the last couple of months drive home the critical importance of ensuring that a firm's senior managers engage themselves with regulatory objectives, adjusting approaches to delivery as circumstances change, rather than just focusing mechanically on compliance with prescriptive rules.

More principles-based, outcome-focused regulation is an essential tool both for informing senior management about the objectives of the regulators and for making them accountable for delivery. It is important for boards to recognise that having compensation structures where traders receive immediate reward and do not bear the consequences of losses is a risk to shareholders. The compensation structure should ensure that both employees and shareholders share the risk in good times and bad. Firms should continue to expect increased regulatory attention on their funding and liquidity arrangements and the adequacy of their stress testing. Firms should ensure they can deal with uncertain market conditions and also maintain sufficient focus on other important business, such as the usual controls and regulatory priorities.

Over the coming year, one can expect the regulators to challenge senior management and boards more intensively including a focus on issues, such as:

- How are they ensuring continued compliance with regulatory principles, especially as market conditions change?
- The judgments they make on business decisions.
- Whether they review the consequences of their decisions.
- When developing and selecting business options, whether they give robust consideration to the risks and impact of those risks if they were to come into effect.

As a result, financial institutions must focus on the following principles:

- Strengthened prudential oversight of capital, liquidity and risk management.
- Enhancing transparency and valuation.
- Changes in the role and uses of credit ratings.
- Strengthening the authorities' responsiveness to risks.
- Robust arrangements for dealing with stress in the financial system.
- Consider the potential for new risks going forward.
- Increase liquidity buffers.
- Co-effective firm-wide risk identification and analysis.
- Consistent application of independent and rigorous valuation practices across the firm.
- Timing and quality of information flows up to senior management.
- Breadth and depth of internal communication across the firm.
- Informative and responsive risk measurement and management reporting and practices.
- The balance between risk appetite and risk controls.
 - Increase oversight in setting the risk appetite of banks.
 - Take an enterprise-wide view of risk.
 - Set up governance and control mechanisms and frameworks to ensure that any excesses or transgressions are flagged and reported.
- Regulators expected to take counter-cyclical measures to dampen the credit curve, such as curbing rampant build up of credit during economic boom.
- Pro-active role of senior management in understanding emerging risk:
 - Role of communication and information flow on risk indicators is critical.

- Risk measures that reflect the dynamic nature of risks.
- Qualitative risk indicators that reflect key aspects of risk management practices that cannot be captured by risk measures.
- Increased role of independent directors in risk oversight and governance.

The regulators' focus will continue to be ensuring that all firms maintain adequate financial resources, robust funding and contingency plans. The last nine months have highlighted how crucial it is for firms to look closely at the vulnerabilities inherent in their business models and test for extreme events. For instance, recent events have confirmed the importance of firms maintaining adequate liquidity; institutions would be expected to take a comprehensive view of all possible demands on liquidity that could arise from various sources, on balance sheet or off, and develop plans to meet those demands, even in times of stress.

The primary focus, as per the regulators' view, with regard to liquidity management should be on scenario planning and stress testing. The other aspect is market abuse, which remains a key risk to efficient, orderly and fair markets. Regulators are stepping up their efforts to both help prevent market abuse and to detect and act where abuse has taken place, by strengthening the capacity of their market monitoring department.

Conclusion

For months, economists have debated whether the US is headed towards a recession. Today, there is no doubt. President Bush can tout his US\$150bn economic stimulus package and the Federal Reserve can continue to cut short-term interest rates in an effort to encourage consumer spending, but these moves are unlikely to stop the economy's slide. The severe liquidity and credit crunch that stemmed from the sub-prime mortgage bust is now spreading to broader credit markets; US\$100 barrels of oil are squeezing consumers and unemployment continues to climb. And with the housing market melting down, empty-pocketed Americans can no longer use their homes as ATMs to fund their shopping sprees. It is time to face the truth - the US economy is no longer merely battling a touch of the flu; it's now in the early stages of a painful and persistent bout of pneumonia.

Countries are watching anxiously and hoping that they don't experience the same symptoms. In recent years, the global economy has been unbalanced, with Americans spending more than they earn and the country running massive external deficits. When the sub-prime mortgage crisis first hit headlines last year, onlookers hoped that the rest of the world had enough growth momentum and domestic demand to protect itself from the US slowdown. But making up for the slowing US demand will be difficult, if not impossible.

It is important to note that free, flat and liquid markets hold the promise that has been discussed for years: optimal capital allocation, proper risk distribution, levelling of the playing field between large and small investors, and cheap and efficient capital formation. The issue is that several factors need to hold in order for this promise to be realised. Markets need to be free, flat and liquid, and the current crisis shows us that none of these things are really true. Hopefully, regulators and rule-makers everywhere will rise to the challenge. Over the next 18 months, the industry will face a regulatory backlash. It has already begun with legislators and the press baying for blood and demanding answers.

A basic question, therefore, arises: is the financial system broken, corrupt and in need of reform, or is the system sound, yet subject to external pressures, notably heavy monetary stimulation, with which it could not easily cope? On that diagnosis rests the future of our highly liberalised financial markets.