



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

CURRENT TRENDS IN RISK MANAGEMENT (A REGULATORY PERSPECTIVE)

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Introduction

I would like to thank BACO for inviting me to participate in this conference and to speak on the important issue of risk management. Let me first preface my contribution by noting that the ideas presented here are my own and do not represent the position of the Central Bank of the Bahamas, any of its officers or employees.

In 2003, Jaime Caruana, Governor of the Bank of Spain in a speech to the Risk Summit USA, sponsored by Risk Magazine said the following:

“A risk manager and a bank supervisor share similar interests. A risk manager seeks the best risk measures and management techniques to protect a bank against losses, to hone its competitiveness, and to enhance its profitability and long-term growth. Supervisors advocate sound risk management practices to ensure the adequate capitalization and prudent management of all banks. This, in turn, strengthens the financial sector’s resilience during periods of distress”¹.

The preceding statement makes a clear and critical link relative to the importance of risk management to both regulators and the organizations that they supervise. Against this backdrop, let us now consider some of the current topical issues, discussed in no specific order of importance, which are having significant influence on the risk management landscape.

New Basel Capital Accord (Basel II) – this new accord, a significant improvement on the existing accord (Basel I), is designed to be more risk sensitive addressing additional risk factors not considered by its predecessor framework. With a more risk sensitive approach it will certainly revolutionize risk management in banks.

¹ Keynote address by Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, to the Credit Risk Summit USA 2003, sponsored by Risk Magazine, New York, 27 October 2003.



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The new accord has three pillars, namely minimum capital requirement, supervisory review and market discipline. Under the first pillar, in order to determine capital adequacy a bank have to calculate charges for credit, market and operational risk. The previous accord had no measurement for operational risk. This is one of the revolutionary but equally challenging aspects of this new accord mainly because the level of organizational knowledge applicable to operational risk is significantly less than in the case of the other two risk elements.

The imposition of the other two pillars injects a significant level of discipline firstly through the review to be carried out by the regulator and then the requirement to disclose its risk management approach and exposure. Getting it right is now extremely more important.

Understanding and application of the framework will be a critical factor in any banks compliance with regulatory capital requirements.

A regulatory framework is being developed by insurance regulators, similar in nature to Basel II in that it will incorporate a three pillar approach. Again the focus is on risk sensitivity in determining the adequacy of capital and reserves of these financial institutions. Undoubtedly this too will influence how risk is managed.

One other trend is the significant changes which are resulting in a converging of **regulatory, accounting and economic capital**. Regulatory capital imposed by regulators and accounting capital based on generally accepted accounting standards are trending closer to economic capital a measurement which in broad terms refers to the maximum capital an organization needs to protect itself from the potential downside risk inherent in its business activities.

It would appear that regulators are also having a significant impact on the development of accounting standards. Consider the recent situation in Europe where the EU refused to accept IAS 39 on a whole scale basis given concerns that particular elements of its requirements, particularly cash flow hedges and the fair valuing of liabilities, could adversely affect the adequacy of banks' capital. Having agreed the basic principles of a compromised position, these rules are now being developed.

Enterprise risk management is a new trend which has emerged to redefine the process of risk management. The widely respected COSO organization has recently published a full scope document on the topic. At its foundation is the call for a holistic approach to the, management of risk. There is a clear recognition that managing risks in isolation (in silos) can be counterproductive as it detracts from the principles and benefits of effective portfolio management. Portfolio management essentially argues that the whole is less than the sum of its parts. In other words 1 plus 1 is always less than 2.



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Enterprise Governance, a fundamental shift from corporate governance which essentially is a conformance approach. Enterprise governance is a more proactive approach to executing stewardship over an organization where like enterprise risk management it emphasizes a holistic approach together with being performance oriented.

Credit derivatives, this ever evolving, but by no means new, approach to the management of credit risk is literally changing the face of balance sheets of all organizations. A credit derivative, in its basic form, is a contract purchased by a bank or other financial institution to protect itself if a borrower can't repay a loan or fulfill a lease obligation. This approach to risk management diversifies risk or reduces the amount of capital that institutions must set aside to cover possible defaults.²

By making the link to minimum capital requirements, mentioned above, the implications for financial institutions become clear. The ability to free up capital in this way expands the opportunity to take on greater risks for greater rewards. Regulators therefore have a keen interest in their use.

Securitization, like credit derivatives, as a risk management tool, securitization is not new. It is however taking on greater prominence and is being used more innovatively with a range of mainly credit related products being securitized and sold off the balance sheet. This credit risks management tool is gaining prominence in the region. Due to the lack of highly liquid capital markets these transactions are likely to be between financial institutions. From the regulators' perspective therefore it is simply a transfer which continues to have the same implications for financial system. Notably, it is usually low to moderate risks accounts which are sold leaving the seller holding the higher risk ones. The implication is obvious from a regulator point of view as greater attention will have to be paid to these institutions. Regardless securitization remains attractive to financial institutions giving them the ability to make significant gains, as long as they price their product properly, relative to the level of risks they are accepting.

Business Continuity, events such as 9/11, the 2004 hurricane in the Cayman Islands, the Tsunami in Asia, amongst others, have brought the focus on business continuity full center. Regulators are more and more imposing explicit requirements for this critical aspect of institutions risk management systems. While there is nothing revolutionary about this requirement it increases the focus on operational risk and drives home the importance of planning for adverse eventualities. Note that the most profitable entity with the best implemented risk management system, if it fails to restart its operations on timely basis, following a significant adverse event, is likely to go out of business.

Sarbanes-Oxley Act, mainly due to its impact on financial governance and the imposition of the COSO internal control framework for the assessment of control

² MckinseyQuarterly (www.mckinseyquarterly.com)



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systems, this act is having a significant impact on the risk management of organization throughout the world. As a result of the presence of numerous US registered issuer of shares Sarbanes has influence not only public companies for which it is targeted but is becoming the “golden standard” for all other organizations. Note that effective governance is a priority issue for all regulators.

Compliance Function in banks. I would be remiss not to mention the recent document issued by the BIS committee on banking supervision encapsulating 12 principles to guide the management of compliance risk and the compliance function in general. This document is significant if only in the fact that its clearly recognizes Compliance as an independent function making a clear demarcation from internal audit and, in discussing its responsibilities, noting that it should be to assist management in effectively managing compliance risk³. Not to restrict business as is sometimes stated by some individuals who seems not to not having a sound appreciation of the role of Compliance.

Finally, the use of **Risk Adjusted Profit Measures (RAPM)** such as risk adjusted return on capital (RAROC) and return on risk adjusted capital (ROROC) is taking on greater popularity worldwide. These measures were developed to address observed weaknesses in accounting measures such as return on equity (ROE) and return on assets (ROA) and the use of EPS and P/E ratio in determining the value of an entity. These accounting measures do not fully account for the economic realities of the entities neither do they take into account the risks inherent in the institutions operations.

There is a trend, started in the mid nineties, which advocates a concentration on economic value added (EVA) and shareholder wealth maximization (SWM) which is based on these economic risk measures. These two elements, having taken on renewed life, especially in the US and Britain, will more than anything else, change the way risk management is viewed. The need to create wealth dictates that business activities undertaken are not only profitable but represents “wealth creating units”.

The determination of this “wealth creation” lies largely in the calculation of measures such as capital at risk (CAR) [the equivalent to value at risk (VAR) in trading securities] and economic capital to facilitate effective capital allocation. The efficacy of these measures lies fundamentally in the application of sound, structured and quantitative risk management practices. And before you indicate that it is not applicable to the small financial institutions of the Caribbean consider the effect that their direct competition, having parents in the “big countries”, will have when they start applying them.

Conclusion:

³ Basel Committee on Banking Supervision – Compliance and the compliance function in banks, April 2005



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The trends discussed above are by no means comprehensive but represents some of the significant development which are having an especially global impact. They all represent challenges for regulators and financial institutions alike but also represent significant opportunities for innovative management and for individuals seeking to launch new careers or to “diversify” current ones. Regardless of how you see these issues impacting you and your organization it is imperative that proactive steps are taken to assess their potential impact and well thought out preparation taken to response to them. To not do so, in this dynamic and innovative era is essentially tantamount to a failure in exploiting the opportunities they present and very crucially putting ones organization at a competitive disadvantage.

Ladies and gentlemen, Thank you.