



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

**TRENDS IN RISK MANAGEMENT DISCUSSION POTENTIAL
NEED FOR PROFESSIONALS AND IMPLICATIONS FOR THE
BAHAMAS**

Presented by Hubert Edwards

To the Bahamas Association of Compliance Officers (BACO)

On October 28, 2005

At the Hilton Hotel

Nassau, Bahamas.

* * *



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

INTRODUCTION

Ladies and gentlemen, it is certainly a privilege for me to be here this afternoon to have this reasoning session with you. I would also like to thank BACO and its executive for inviting me to speak at this luncheon meeting today 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 those of the Central Bank of the Bahamas, any of its officers or employees.

The issue of risk and uncertainty has both fascinated and baffled people for many many years. The one absolute consensus that emerges from the debates and by observing reactions to the issue is that uncertainty, risk and risk management means different things to different persons. This difference in opinion is so profound that any two persons within the same organization, addressing the same or similar issues, tend to have different views on risk and risk management.

I refer to it as a reasoning session because it is my intention to try to appeal while hopefully bring some level of information to you. My intention this afternoon is not to present a lecture on either risk or risk management but to briefly highlight some trends, initiatives, developments and practices which are influencing increase focus on these matters and attempt to make a link to the importance of “getting on the bandwagon” now, for want of a better term. I also intend to briefly elevate the discussion to focus on its national import.



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

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 capitalisation 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. I use the statement in my quest to establish some level of credibility for speaking on today’s topic.

Let’s consider firstly what drives the desire for risk management and therefore creates a demand for risk professionals. Simple put it is the need to solve the risk reward dilemma faced by all business activities. The question is what level of risks we are willing to accept for a given level of reward or vice versa. The answer to this question is dictate by a number of things chief among which are the risk appetite of the institution and the explicit recognition for creation of shareholders value, the main (or supposed to be) reason for the creation of a business enterprise.

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.



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

NEW BASEL CAPITAL ACCORD (BASEL II) – this new accord, a significant improvement on the existing one, is designed to be more risk sensitive addressing additional factors not considered by its predecessor frame work. With a more risk sensitive approach it will certainly revolutionize risk management in banks. I expect that there will also be a favourable “spill over” into other financial and non-financial institutions. Note however that as we speak the US is in the process of finding ways of increasing the sensitivity of Basel I.

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 new 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



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

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.



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

ENTERPRISE GOVERNANCE, a fundamental shift from traditional 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. **MANGING FOR RESULTS AND VALUE.**

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. **CONSIDER THE IMPLICATION FOR AN EXPANDED CONTRIBUTION OF THESE INSTITUTIONS TO THE LOCAL ECONOMY.**

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

² MckinseyQuarterly (www.mckinseyquarterly.com)



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

institutions. From this 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 risk management 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 AND OPERATIONAL RISK, events such as 9/11, the 2004 hurricanes in the Cayman Islands, Bahamas, New Orleans, Florida; the Tsunami in Asia; earthquake in Pakistan 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 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



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

becoming the “golden standard” for all other organizations. Note that effective governance is a priority issue for all institutions. This is so important that only this week COSO issued a draft document providing guidance on how small businesses can effectively comply with Sarbanes Oxley’s section 404. While I have not yet read the document I think that it will hold significant relevance to us here in the Bahamas given that relatively even our largest corporations would fall within its scope.

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 it 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 who lack a sound appreciation of the true role of the Compliance Function.

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.

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



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

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 and managers rewarded. The need to create wealth dictates that business activities undertaken are not only profitable but represents “wealth creating units”. *Positive npv together with best profitability index creates shareholders value. Otherwise it destroys value.*

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.

IMPLICATIONS FOR YOU AND THE BAHAMAS

Clearly as we move forward there is going to be a greater demand for risk managers. With a more risk oriented view to management driven by and employing the initiatives and practices we just discussed there will be a need for practitioners who can lead from the front, essentially trailblazers creating where there is nothing and developing systems that don't yet exist or if they do are not defined and sufficiently structured to



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

address the underlying complexities of the organizations business activities and the challenges of the global dynamics. Note that this trend has started; persons are being drawn substantively into the risk management field. However, one of the significant deficiencies currently is the lack of a support system. Members of BACO, more than anyone else, understand this issue. After all it was out of a clear recognition for this said support mechanism that BACO was born. I think that we are at the dawning of a new era, locally, which if embraced could present significant opportunities for personal and professional growth.

But more importantly, in my view is the potential impact on the country, the Bahamas. A large part of what is being parlayed as financial products in the world today was created out of a need to management a particular risk. I speak of the use of derivatives, securitization, and complex tax planning schemes and wealth management structures etc. In response to or in conjunction with these products there is the growth in disciplines such as financial engineering, professional risk manager, credit, market and operational risk specialists and specialist insurance professionals.

By developing unique products, initially for risk management purposes, which are recognized to have speculative value important financial products are created. It means therefore that local developments in the realm of risk management, materializing as just outlined, could have a significant upside potential for not only the diversification of financial services but also what I would term a potentially redefining the financial services industry to compete not only with the traditional offshore centers but also with the new and emerging ones such as Singapore and others which are popping up in Asia.



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

This can be achieved while very importantly while ensuring that we continue to remain relevant to other major financial centers such as New York and London.

CONCLUSION:

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 all organizations 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 or 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 while simultaneously increasing the risk of loss of shareholders’ value. The implications for the Bahamas, while it will not materialize overnight are profoundly clear.

Ladies and gentlemen, Thank you.