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Risk Management: Lessons to be Learned from the Current Global Financial Crisis

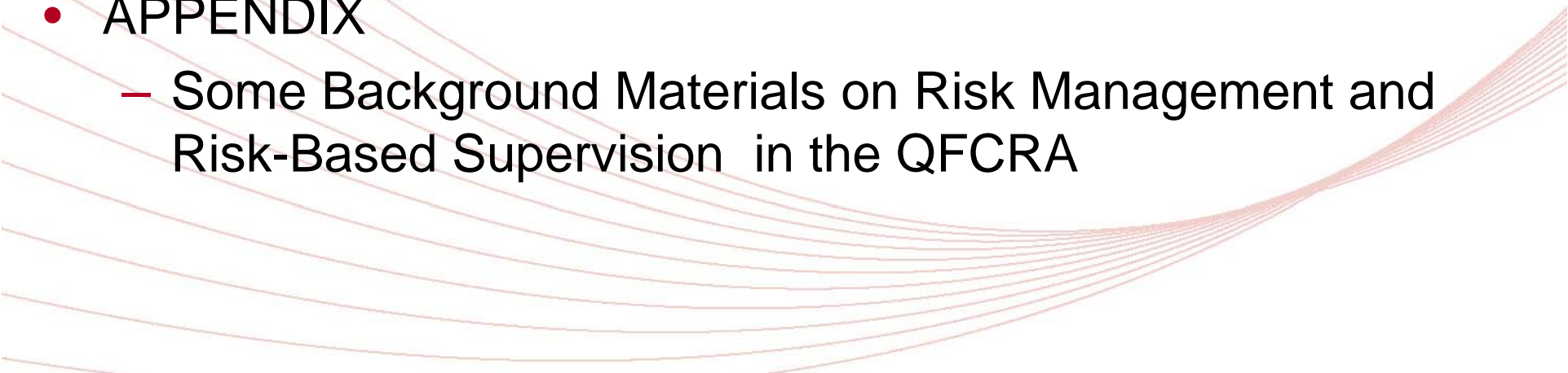


**The Institute of Risk Management Middle East Group
Doha, 9 November 2008**

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Qatar Financial Centre Regulatory Authority

Overview

- What went wrong?
 - The short version
 - The slightly longer version
 - Senior Supervisors Group: *Observations on Risk Management Practices*
 - Enterprise Risk Management
 - What should good risk management look like?
 - APPENDIX
 - Some Background Materials on Risk Management and Risk-Based Supervision in the QFCRA
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What went wrong?

The short version

1. US firms, mainly mortgage bankers and brokers **who** either **didn't understand the risk** or didn't care, made a lot of "subprime" (i.e., bad) loans
2. These loans were "packaged" into a variety of complex financial products by banks and investment banks and sold to (mainly) institutional clients **who didn't understand the risk.**
3. When the loans went bad, the banks and investment banks, **who didn't understand the risk**, ended up taking big losses
4. So did banks and other institutions around the world, **who didn't understand the risk**, who were trading or investing in these products.

What went wrong?


The short version (cont'd)

5. A number of large financial institutions, **who didn't understand the risk**, posted huge losses, a few went under.
6. Other financial institutions who had originated, traded or held complex financial products (some related to subprime mortgages, some not) and **who didn't understand the risk**, had to reprice their holdings to market and, in some cases, take off-balance sheet risk onto the balance sheet, and also posted huge losses. A few more went under.
7. Institutions like AIG which issued credit insurance or relied on it, and **who didn't understand the risk**, began to take huge losses.

What went wrong?

The short version (cont'd)

8. Financial firms around the world, **who didn't understand the risk** they had been taking stopped lending to other financial firms.
9. More firms, **who didn't understand the risk** they had been taking, ran out of funds and central banks around the world had to pump in massive amounts of liquidity.
10. More firms, **who didn't understand the risk** they had been taking (e.g., Lehman Brothers) failed or had to be rescued (i.e., AIG and a host of others).
11. Credit markets around the world seized up and central banks had to and continue to pump in massive liquidity, capital, guarantee deposits and keep the financial systems running.



Do we see a
pattern emerging
here?

What went wrong?

The slightly longer version

- Complacency on the part of regulators and bankers
 - Regulators lost their focus
- Poor execution of the basics by the regulators
 - Credit Risk
 - Liquidity Risk
- Weakness in underwriting principles
- Poor risk management
 - too large concentrations,
 - lack of awareness of true extent of risk

What went wrong?

The slightly longer version

- Uncertainty in the valuation practices
 - Level of risk grossly underestimated by many firms
- New and untried instruments carry higher risks and should have been subject to higher capital charges.
 - There was insufficient data and faulty assumptions in rating the paper.
- Near exclusive reliance on rating agencies was a mistake.

What went wrong?

The slightly longer version

- Need to assure sound underwriting and identification of firm-wide risk concentrations
- Expanded use of the originate to distribute model
 - Banking of origination fees and no stake taken in the risk.
- Lack of thorough analysis by buyers of risk
 - over reliance upon the underwriters
 - over reliance upon the rating services.

What went wrong?

The slightly longer version

- Need to do better job of capturing risk
- Underpricing of risk—WHY?
- Obfuscation of risk
- Excess growth
- Did not understand probability of default
- VAR standards were insufficient
- Shortcomings in stress testing

Senior Supervisors Group Conclusions

Four firm-wide risk management practices that differentiated performance are:

1. Effective firm-wide risk identification and analysis;
2. Consistent application of independent and rigorous valuation practices across the firm;
3. Effective management of funding liquidity, capital and the balance sheet; and
4. Informative and responsive risk measurement and management reporting and practices.

Source: **Senior Supervisors Group**: *Observations on Risk Management Practices During the Recent Market Turbulence, March 2008*

Senior Supervisors Group Key Observations - Summary

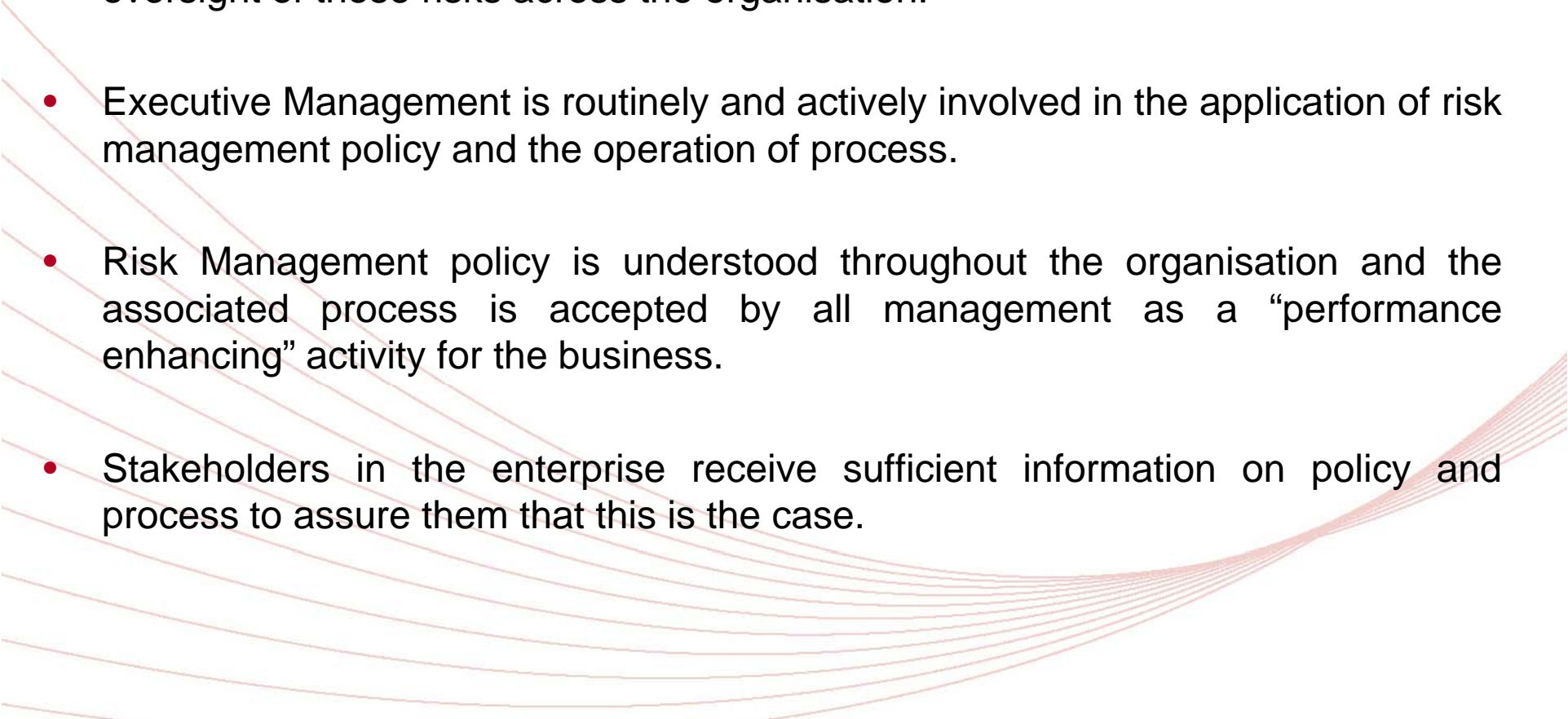
- **Senior management oversight**
 - The balance between risk appetite and controls
 - The role of senior management in understanding and acting on emerging risks
 - The timing and quality of information flow up to senior management
 - The breadth and depth of internal communication across the firm
- **Liquidity risk management**
 - Planning and managing internal pricing for contingent events
 - Funding liquidity management during the stress event
 - Contingency funding plans
- **Credit & market risk management**
 - Credit underwriting and reporting
 - Valuation practices
 - Risk measures
 - Stress-testing and scenarios-analysis
 - Hedging and counterparty risk management

Source: **Senior Supervisors Group: Observations on Risk Management Practices During the Recent Market Turbulence, March 2008**

Enterprise Risk Management – essential core process elements

- Set a risk appetite
 - Agree and communicate your risk strategy
 - Clear Governance of Risk
 - Necessary Infrastructure is in place
 - Individual risks are proactively identified
 - Risks are measured
 - Risks are managed
- 

What should good risk management look like in a firm? *

- The board is pro-actively involved in setting clear strategic objectives for the organisation, understands the risks threatening the realisation of those objectives and has put in place a policy and process for the management and oversight of those risks across the organisation.
 - Executive Management is routinely and actively involved in the application of risk management policy and the operation of process.
 - Risk Management policy is understood throughout the organisation and the associated process is accepted by all management as a “performance enhancing” activity for the business.
 - Stakeholders in the enterprise receive sufficient information on policy and process to assure them that this is the case.
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Thank you.

Any questions?



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APPENDIX

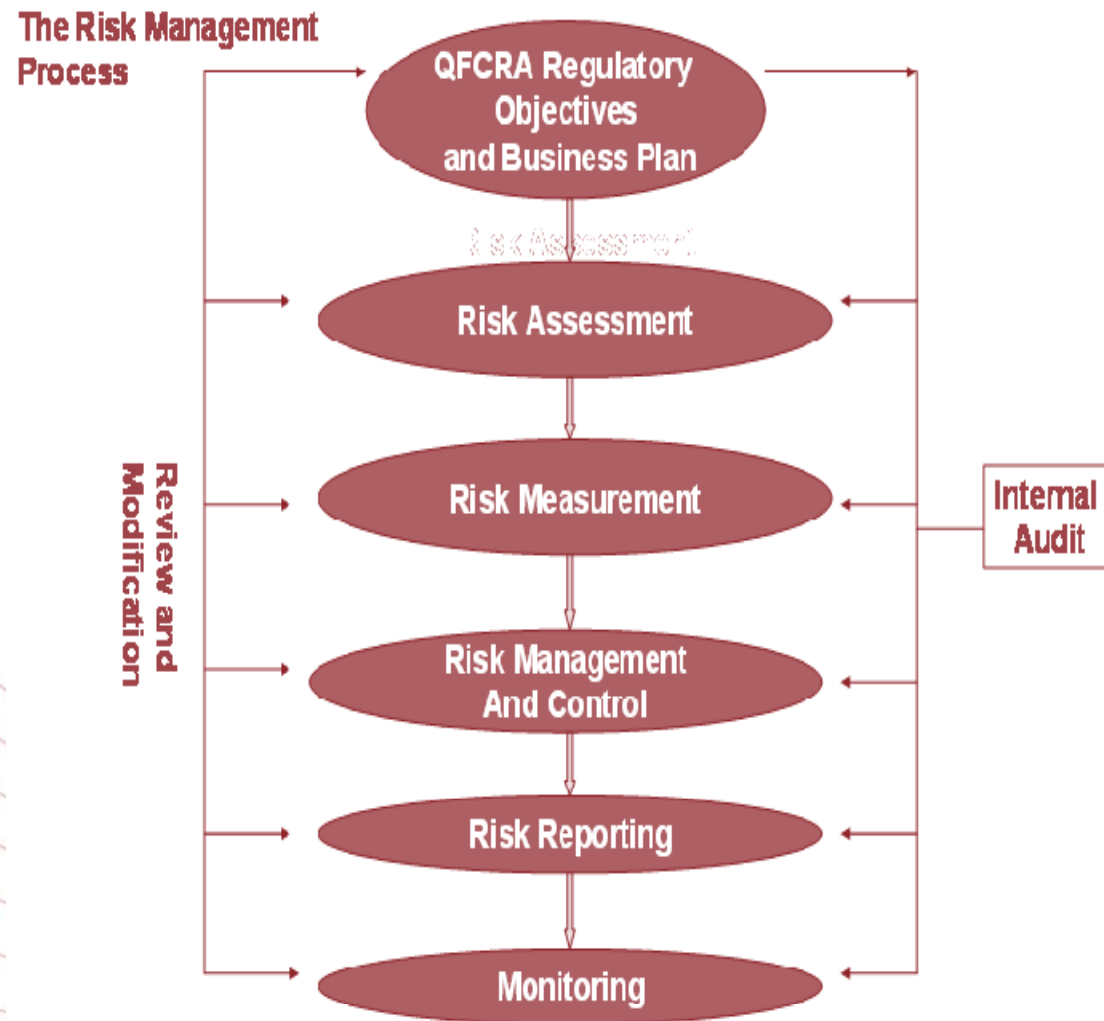
Some Background Materials on Risk Management
and Risk-Based Supervision in the QFCRA

Appendix

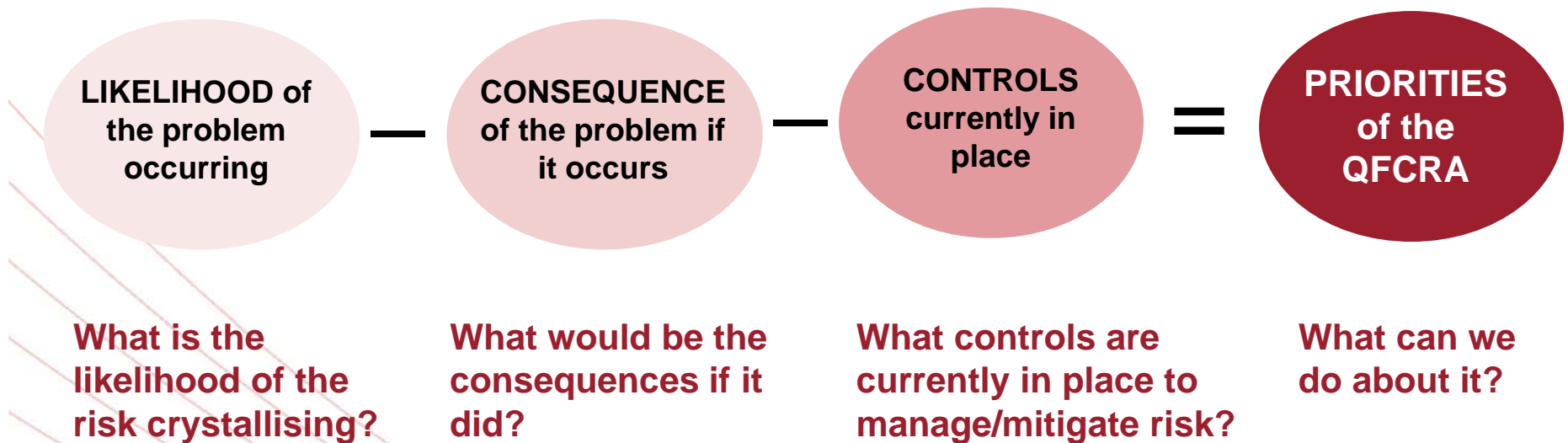
- QFCRA Risk Management
 - Principles of good Risk Management
 - What is risk-based regulation?
 - Benefits of a risk-based approach to regulation and supervision
 - QFCRA supervision approach
 - QFCRA supervision approach
 - Authorised firm Risk Assessment Table
 - How the QFCRA measures firm risk
 - Detailed Risk Assessment
- 



QFCRA risk management policy & process



QFCRA risk management at the organisational level



QFCRA risk management goals & objectives

- Ensure, as far as possible, all material risks to which the QFCRA is exposed are identified, measured, evaluated and managed on a stated and agreed basis.
- Design and embed an Enterprise Risk Management process throughout the organisation.
- Ensure the QFCRA builds and improves its capabilities in order to respond effectively to all types of risks.
- Ensure all staff are aware of their responsibility for managing risk within the QFCRA.
- Ensure risks are reported in a timely manner to the Managing Directors, Executive Committee, Audit and Risk Committee and the Board.

QFCRA principles of good risk management

QFCRA risk management

- Embedded throughout the organisation.
- Employees recognise and assume responsibility for managing risk.
- QFCRA Board is responsible for monitoring risk, assisted by the Audit & Risk Committee.
- Relevant laws and codes of conduct are implemented dynamically and proactively, as deemed appropriate.
- Risk is reported using an enterprise-wide approach.

What does it mean to the QFCRA?

- Achievement of Regulatory Objectives
- Getting the right balance between innovation and change and avoiding shocks and crises.
- A collective approach to managing risks.
- Sound risk governance in principle and practice.

What is risk-based regulation?

- A regulator cannot set out to eliminate *all* failures from the financial system.
- It is inevitable that we will see consumers within the GCC suffer financial loss, there will be a certain level of financial crime; and that some of the regulated firms in the GCC will suffer financial failure.
- A regulator must therefore make conscious choices as to which risk it seeks to mitigate. How a regulator makes those choices, such as the factors it takes into account, is its risk-based approach.

Risk-based regulation: opportunities & challenges ahead

- Continuous review of risk operating practices, policies & guidelines;
- Educating firms on what principles based regulation means;
- Assuring proper corporate governance;
- Customising the approach for GCC organisations;
- Alignment with global and regional initiatives and standards (IOSCO, Basel, IMF, etc.);
- Setting common frameworks; and
- Getting the right balance.

Risk-based regulation: aligning with relevant best practice

Strengthen efficacy and robustness of regulation and standards with global, regional and local best practices by:

- Reviewing regulatory frameworks to enhance the incentives for relevant financial stakeholders to develop forward-looking approaches developing holistic approaches to risk management (beyond capital measures);
- Ensure that the regulatory framework sets sufficiently high standards taking into account lessons learned;
- Review and strengthen as appropriate existing guidance and regulation on risk management and other critical business practices such as valuation, as well as the controls and monitoring of both; and
- Continue to actively engage in, support and encourage dialogue and collaboration where feasible, timely and appropriate.

Adapted from: Senior Supervisors Group - Observations on Risk Management Practices during the Recent Market Turbulence (March 6, 2008)

Let not “radical reform be flawed by compromise”

- History tells us that the scope for regulatory reform is directly proportionate to the severity of the crisis.
- The rescue of Bear Stearns and the deepening impact of the credit implosion on the real economy make it clear that radical financial re-regulation now looms.
- The snag is that radical remedies may not gravitate towards the right problems.

Source: Financial Times (April 2008).

Benefits of a risk-based approach to regulation & supervision



Benefits for the regulator

- Optimum use of resources.
- Facilitates a pro-active approach.
- Reliance on firms' senior management.
- Principle based regulations over rules.
- Flexible & responsive supervision, also tailored to a firms risk profile & unique characteristics.

Benefits for regulated firms

- Firms control their own risks.
- Less intensive and intrusive supervision.
- Principle based regulation less prescriptive.
- Reduced costs.

US & UK approaches

- **Risk assessment**
 - Rating each element of risk and its direction.
- **Supervisory plan**
 - Customised based on the risk assessment.
- **Continuous supervision**
 - Covering large and complex banking organisations.



QFCRA supervision approach

In applying the risk based approach, the Supervision Division:

- Maintains close relationships with each firm and its senior management;
- Co-operates with other regulators to try to ensure that firms which are branches or part of a group are effectively supervised but not overly burdened with regulatory requirements that duplicate those imposed by their home state regulator;
- Maintains a continuous cycle of risk management which enables it to regularly undertake the risk assessment and classification of firms using a standardised methodology; and
- Focuses on achieving our objectives by making effective use of the supervisory tools available to it.

Authorised Firm Risk Assessment Table

Business Risks

RISK GROUPS	RISK FACTORS	EXPLANATORY NOTES
Financial Soundness	<ul style="list-style-type: none"> Capital Adequacy 	The risks arising from the nature of the Authorised Firm's capital position. These include the firm's capital planning framework, the composition and quality of capital, the adequacy of capital to support the level of current and anticipated business activities, the adequacy of reserves and access to further capital.
	<ul style="list-style-type: none"> Revenue / Profitability 	The risks arising from the nature of earnings of the Authorised Firm. These include the adequacy of profitability, volatility of revenues and profitability and track record of performance against budget.
Business Strategy	<ul style="list-style-type: none"> Quality of Business Strategy and Plan 	The risks arising from the overall strategy of the Authorised Firm. These include the quality of the strategic planning process, the achievability of the strategy, the implications of the strategy, particularly for risk appetite, and the track record of implementation.
	<ul style="list-style-type: none"> Regulated Activities Offered 	The risks arising from the characteristics of the business that the Authorised Firm is conducting including the extent and complexity of those activities.
	<ul style="list-style-type: none"> Types of Clients 	The risks arising from the characteristics of the Authorised Firm's client base including the types of clients (Market Counterparties, Business Customers, Commercial Customers and Retail Customers).
	<ul style="list-style-type: none"> Types of Products 	The risks arising from the characteristics of the current products or services provided by the Authorised Firm. These include complexity, tenor and performance of the products.

Authorised Firm Risk Assessment Table

Business Risks

RISK GROUPS	RISK FACTORS	EXPLANATORY NOTES
Business Strategy	<ul style="list-style-type: none"> Markets Targeted 	The risks arising from the markets targeted including the location of clients and the nature and jurisdiction of overseas investments offered.
	<ul style="list-style-type: none"> Sources of Business and Distribution Channels 	The risks arising from the nature of the current sources of business to and distribution mechanisms used by the Authorised Firm. These include introductions by existing clients and the use of intermediaries and sourcing of overseas customers.
Market and Operational	<ul style="list-style-type: none"> Market Risk 	The risks arising from the type and nature of market risk undertaken by the Authorised Firm. These include the risk appetite of the Authorised Firm, the nature of market risk exposures involved in the Authorised Firm's products and services.
	<ul style="list-style-type: none"> Credit Risk 	The risks arising from the type and nature of credit risk undertaken by the Authorised Firm. These include the risk appetite of the Authorised Firm, the nature of counterparty exposures involved in the Authorised Firm products and services, portfolio characteristics and the nature and extent of credit risk mitigation.
	<ul style="list-style-type: none"> Operational Risk 	The risks arising from the type and nature of operational risk involved in the Authorised Firm's activities. These include direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.

Authorised Firm Risk Assessment Table

Business Risks

RISK GROUPS	RISK FACTORS	EXPLANATORY NOTES
Market and Operational	<ul style="list-style-type: none">Operational Risk	The risks arising from the type and nature of operational risk involved in the Authorised Firm's activities. These include direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
	<ul style="list-style-type: none">Liquidity Risk	The risks arising from the type and nature of the Authorised Firm's liquidity or asset and liability mix. These include the liquidity management framework and the composition of liquidity to allow funding of the operational and financial obligations of the business both day to day and in crisis situations.
	<ul style="list-style-type: none">Insurance Underwriting	The risks arising from the type and nature of insurance underwriting risk undertaken by the Authorised Firm. These include the risk appetite of the firm, the nature of insurance underwriting exposures involved in the firm's products and services and the nature and extent of reinsurance cover.
	<ul style="list-style-type: none">Legal Risk	The risks arising from the type and nature of the Authorised Firm's contractual agreements. These include the risk that contracts may not be enforceable under applicable law.

Authorised Firm Risk Assessment Table

Business Risks

RISK GROUPS	RISK FACTORS	EXPLANATORY NOTES
Organisation and Regulation	<ul style="list-style-type: none">Clarity of Legal Ownership and Structure	The risks arising from the structure of the Authorised Firm or group. These include the nature of the legal and ownership structure and openness of the group structure to regulators.
	<ul style="list-style-type: none">Controllers and Group Entities	The risks arising from the characteristics of the controllers of the Authorised Firm. These include the jurisdiction and characteristics of shareholder controllers, directors, and nature of other group entities. The risks arising from the relationship between the Authorised Firm and the rest of the group. These include management arrangements, reliance on centralised functions, financial health and activities of the wider group and financial and other dependencies on other group entities.
	<ul style="list-style-type: none">Nature and extent of Home State Laws, Regulation and Supervision	The risks arising from the content of applicable laws (such as statutory priority to local creditors), the level of regulation undertaken by another financial services regulator and the reliance that can be placed on the supervision of the firm by that regulator.
	<ul style="list-style-type: none">Political and Economic Environment in Home Jurisdiction	The risks arising from any instability in political or environmental factors in the Authorised Firm's home jurisdiction. This may include terrorism, political sanctions or likelihood of natural disasters.
	<ul style="list-style-type: none">Relationship with Regulators	The risks arising from the nature of the Authorised Firm's relationship with other regulators, including recent regulatory history.

Authorised Firm Risk Assessment Table

Control Structure Risks

RISK GROUPS	RISK FACTORS	EXPLANATORY NOTES
Clients	•Communication with Clients and Financial Promotions	The risks arising from the nature of financial promotion and advertising practices employed by the Authorised Firm.
	•Client Assets	The risks arising from the firm holding or controlling of client's or user's monies and assets.
	•Client Categorisation	The risks arising from customer classification and the documentation procedures.
	•Advice, Management and Dealing	The risks arising from dealing and managing customer assets and the quality of advice (e.g. suitability, customer understanding of risk and charges).
	•Disclosure and Reporting	The risks arising from the nature of product literature issued by the Authorised Firm and the terms of business, periodic statements and other documentation provided to clients.
Conflicts Management	•Identification and Management	The risks arising from the identification of potential and actual conflicts of interest and the way that they are managed by the Authorised Firm.
	•Staff Remuneration	The risks arising from the recruitment quality and training procedures for the sales force. The risks arising from the nature of the remuneration scheme for employees.
	•Personal Account Dealing	The risks arising from potential insider dealing and the process for identifying and approving directors and employees trading for their personal accounts.

Authorised Firm Risk Assessment Table

Control Structure Risks

RISK GROUPS	RISK FACTORS	EXPLANATORY NOTES
Management and Control	•Allocation of Responsibilities	The risks arising from the nature of the allocation and definition of directors' and management responsibilities and the mechanism for ensuring that responsibilities are effectively delegated and carried out.
	•Quality of Management and Corporate Governance	The risks arising from the quality of Authorised Firm's management, the nature of the corporate governance of the firm and overall compliance culture. These include management's experience and integrity, fit with the business and operation of the executive body, non-executive directors and board committees.
	•Reporting Lines and Segregation	The risks arising from reporting lines between management and the board or other senior staff and the appropriate segregation of duties between functions of a risk taking nature and risk management nature.
	•Compliance Function and Arrangements	The risks arising from the nature and effectiveness of the compliance function. These include its mandate, structure, staffing, methodology, reporting lines and effectiveness.
	•Risk Management Systems	The risks arising from the nature and effectiveness of the systems and procedures in place to identify, measure, monitor and control the risk of the business in an appropriate and timely manner. These include credit risk, insurance underwriting risk, market risk, operational risk, legal risk and new product risk.

Authorised Firm Risk Assessment Table

Control Structure Risks

RISK GROUPS	RISK FACTORS	EXPLANATORY NOTES
Financial Crime	•Anti Money Laundering Procedures	The risks arising from the nature and effectiveness of the money laundering controls. These include effectiveness of the MLRO, training, identification of clients, know your business, internal and external reporting arrangements and record keeping arrangements.
	•Prevention of Market Abuse and Financial Crime	The risks arising from the Authorised Firm's susceptibility to having market abuse conducted through it. These include measures to prevent abusive, fraudulent or dishonest trading practices and co-operation in market enforcement matters.
Human and Technical Resources	•Approved Individuals	The risks arising from the assessment of Approved Individuals fitness and propriety and those individuals ability to comply with the Principles of Conduct.
	•IT Systems and Technical Resources	The risks arising from the controls over the IT infrastructure. These include adequacy of resources, procedures for implementation and procurement, effectiveness of security framework, etc. and consideration as to whether the IT infrastructure is an adequate platform on which to run the business.



How the QFCRA measures firm risks

IMPACT of the problem if it occurs



PROBABILITY of the problem occurring



Risk Based Regulatory Approach

Factors include:

- Size of firm
- Perceived importance
- Home country jurisdiction

Factors include:

- Business risk
- Corporate governance
- Control measures

Results in:

- Firm specific Supervision Plans
- Less intensive and intrusive Supervision
- Optimum use of regulatory resources

Detailed Risk Assessment

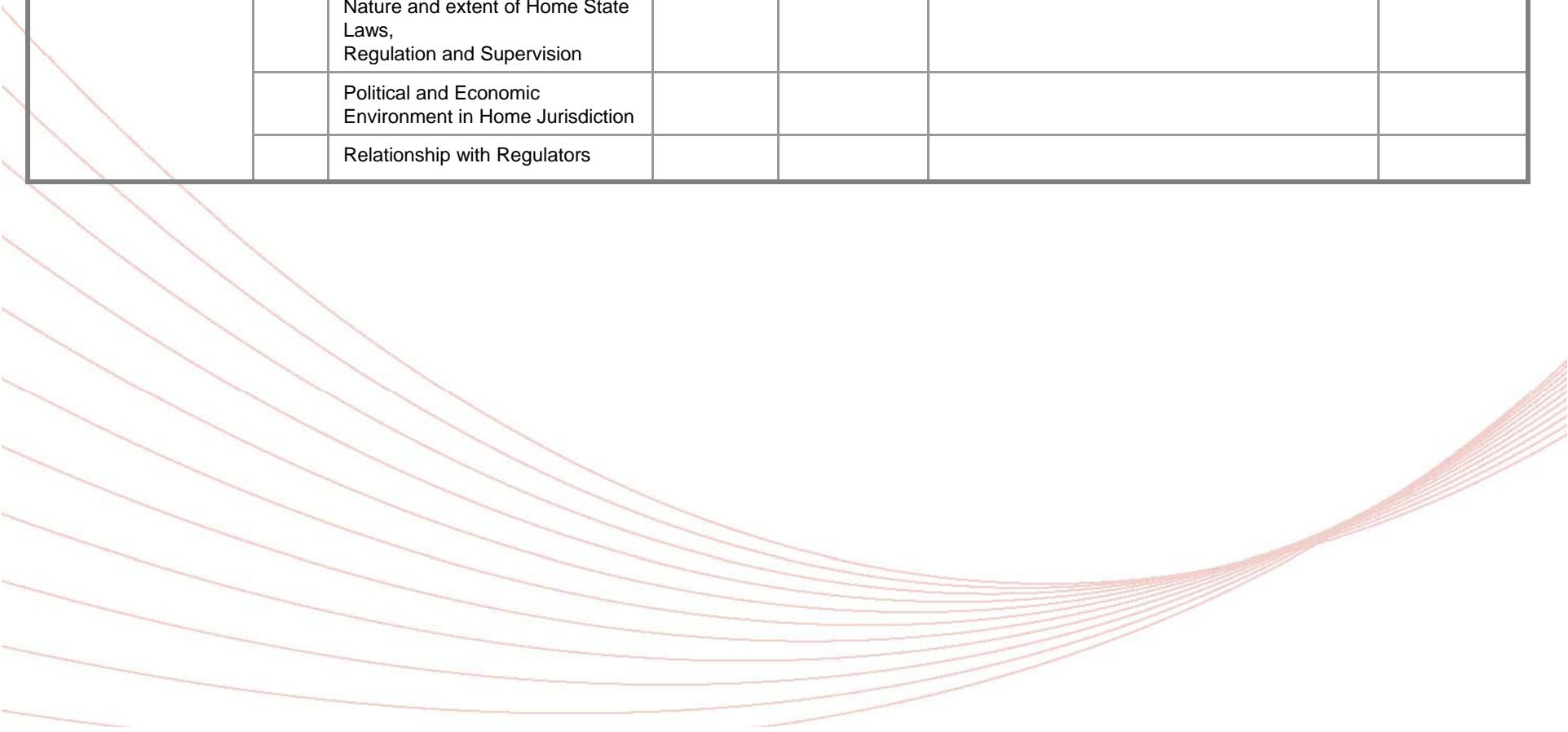
Business Risks

RISK GROUPS		RISK FACTORS	RMP (Issue No.)	RISK SCORE	MATTERS CONSIDERED IN SUPPORT OF RISK SCORE	REF.
Financial Soundness		Capital Adequacy				
		Revenue / Profitability				
Business Strategy		Quality of Business Strategy and Plan				
		Regulated Activities Offered				
		Types of Clients				
		Types of Products				
		Markets Targeted				
		Sources of Business and Distribution Channels				
Market and Operational		Market Risk				
		Credit Risk				
		Operational Risk				
		Liquidity Risk				
		Insurance Underwriting				
		Legal Risk				

Detailed Risk Assessment

Business Risks

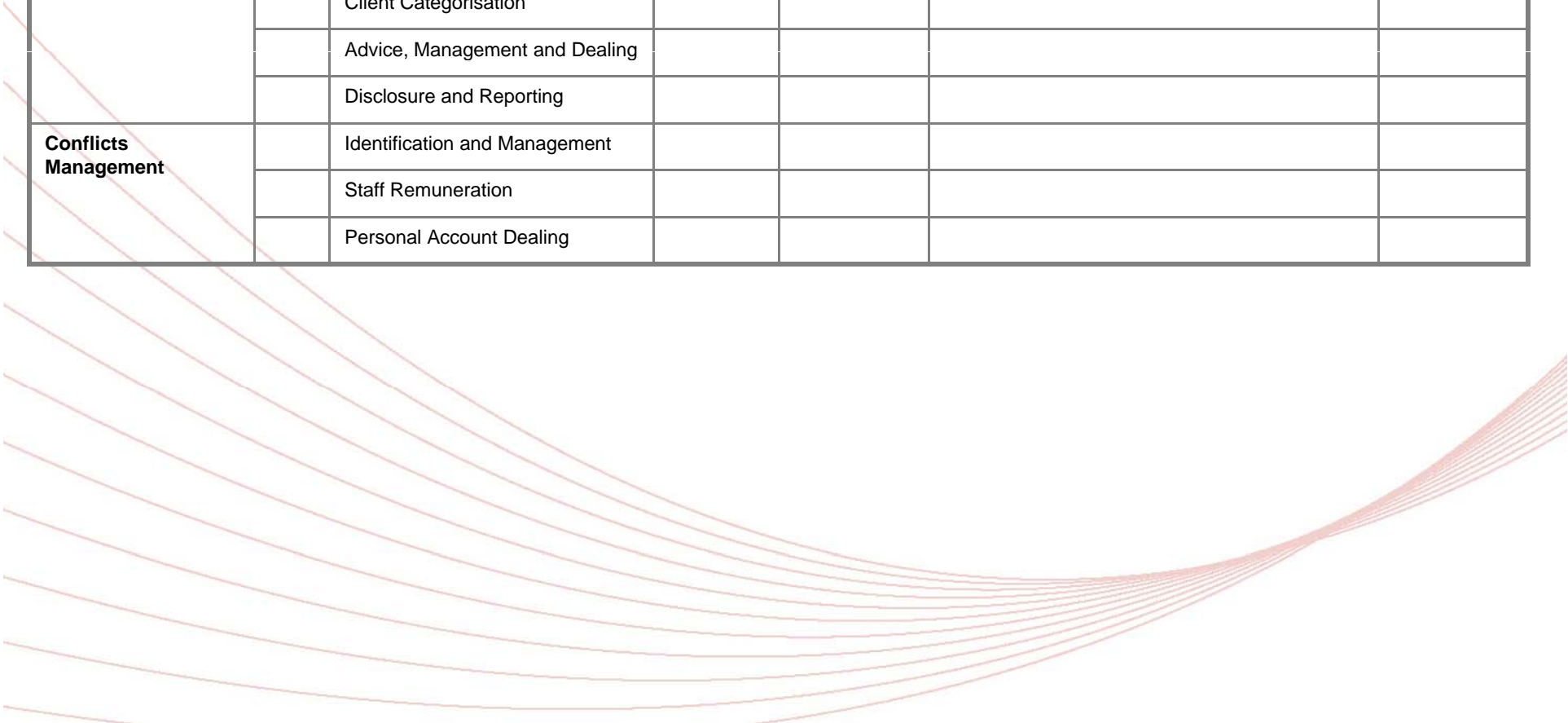
RISK GROUPS		RISK FACTORS	RMP (Issue No.)	RISK SCORE	MATTERS CONSIDERED IN SUPPORT OF RISK SCORE	REF.
Organisation and Regulation		Clarity of Legal Ownership and Structure				
		Controllers and Group Entities				
		Nature and extent of Home State Laws, Regulation and Supervision				
		Political and Economic Environment in Home Jurisdiction				
		Relationship with Regulators				



Detailed Risk Assessment

Control Structure Risks

RISK GROUPS		RISK FACTORS	RMP (Issue No.)	RISK SCORE	MATTERS CONSIDERED IN SUPPORT OF RISK SCORE	REF.
Clients		Communication with Clients and Financial Promotions				
		Client Assets				
		Client Categorisation				
		Advice, Management and Dealing				
		Disclosure and Reporting				
Conflicts Management		Identification and Management				
		Staff Remuneration				
		Personal Account Dealing				



Detailed Risk Assessment

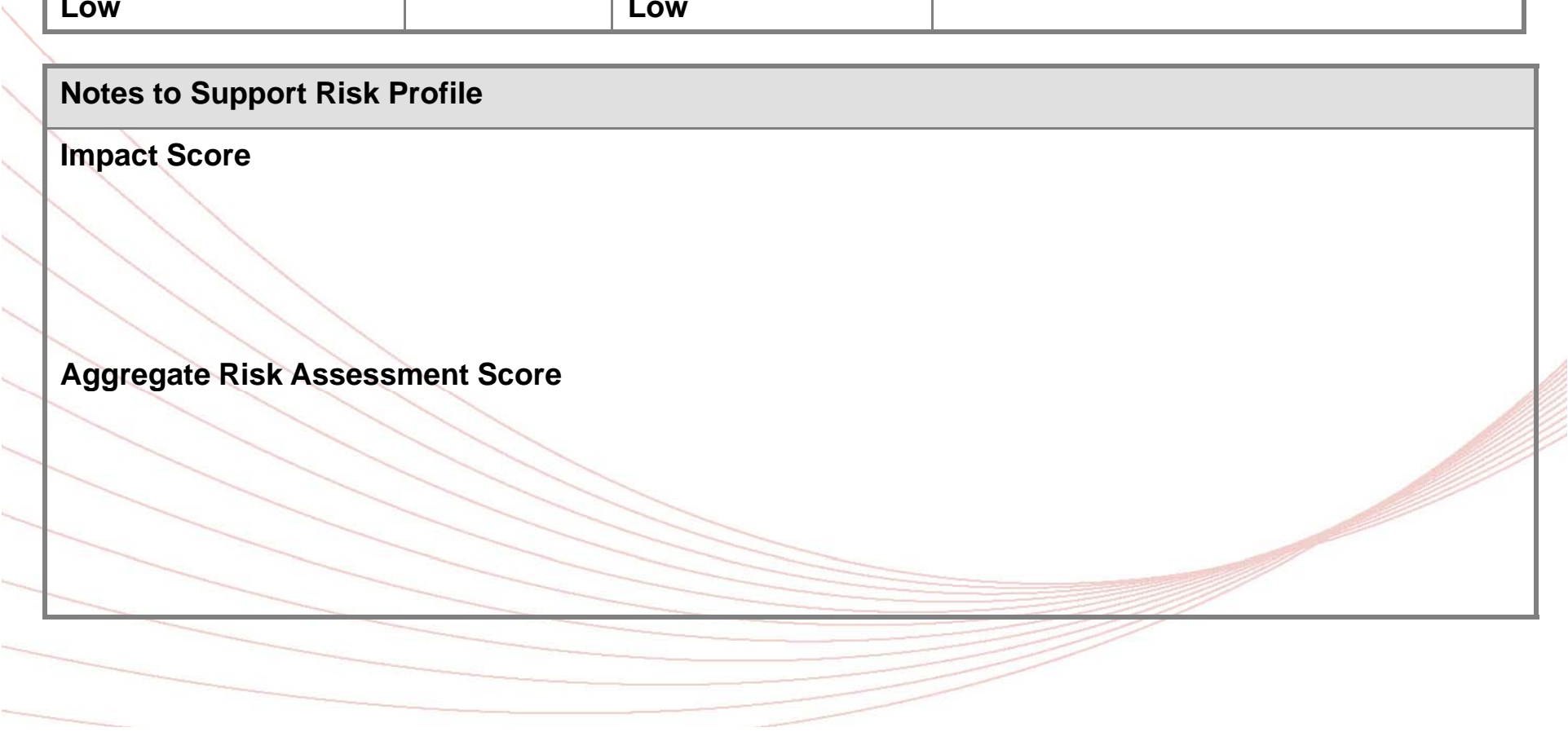
Control Structure Risks

RISK GROUPS	RISK FACTORS	RMP (Issue No.)	RISK SCORE	MATTERS CONSIDERED IN SUPPORT OF RISK SCORE	REF.
Management and Control	Allocation of Responsibilities				
	Quality of Management and Corporate Governance				
	Reporting Lines and Segregation				
	Compliance Function and Arrangements				
	Risk Management Systems				
	Complaints Arrangements				
	Business Continuity				
	Outsourcing				
	Monitoring and Audit				
	Employees and Training				
	Provision of Information to Management				
Confidentiality and Data Protection					
Financial Crime	Anti Money Laundering Procedures				
	Prevention of Market Abuse and Financial Crime				
Human and Technical Resources	Approved Individuals				
	IT Systems and Technical Resources				

Risk Profile

Impact Score		Aggregate Risk Assessment Score	
High		High	
Medium		Medium High	
		Medium Low	
Low		Low	

Notes to Support Risk Profile	
Impact Score	
Aggregate Risk Assessment Score	



Risk Mitigation Program

Authorised Firm Name	
QFC Number	

Agreed By: [Authorised Firm]		Agreed By: [Regulatory Authority]	
Date:		Date:	
Signed:		Signed:	

N	QFCRA Risk Factor	Explanation of Issue	Action	Due date	Person Resp.
1					
2					
3					
4					
5					
6					
7					