# GRAS Newsletter 4

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**Abstract**: With all the attention for troubled banks, it is worthwhile to take a look at the characteristics of banks that are doing comparatively well. These characteristics point to basic risk management principles, which are likely to also receive increased regulatory support.

**Dear reader,**
The Economist noted on October 2 “If a week is a long time in politics, in finance it can be an eternity.” As I write this, on October 9, that is still true and there are a few signs that this will change soon. Although the rollercoaster movements in the financial institutions will die out as the bank valuations settle ever lower, the causes for these dramatic movements will start to lead to a new environment which will have long lasting impacts.

Many commentators have focused on the fire and are analysing what the causes could be for the failure of specific firms. Also, a lot of attention is already given to specific measures now being proposed and executed in various countries. There are four items that, although they may appear less spectacular, also warrant some thought. In this newsletter, I will address these items:

1. Which banks and financial institutions have done comparably well?
2. Can others banks emulate these characteristics?
3. What is the likely *long term* response of regulators?
4. What can risk managers do improve durability for their firms?

**1. Which banks and financial institutions have done comparably well?**
The contagion of toxic debts is clear and has put to bed most de-coupling talk. Despite that, however, it is also becoming clear that not all banks have been affected equally. We find less affected banks among larger as well as smaller banks, internationally active as well as domestic banks, long standing names as well as internet newcomers and investment banks as well as retail banks. Looking for the truly differentiating characteristics, we see the following top banks:

A. Banks that mainly rely on depositors
B. Banks that are not listed
C. Banks that managed to avoid direct poisoning by toxic products, and ‘merely’ need to contend with the fall out of other bank’s mismanaged assets.

**2. Can other banks emulate these characteristics?**
*Depositor reliance*. The normal banking model is set to change and cheap credit will become part of history. The limited funds of depositors will put a cap on growth, but at the same time banks will continue to develop other sources for funds. Also, the traditional answer for attracting funds has been interest rates. This may no longer fly in future, since the general public opinion has finally awakened to the risk/reward relation. Mere percentages will not do the trick of pulling in customers in future.

*Listed companies*. For the second item, we have now seen many banks being de-listed as part of nationalisations across Europe and even in America. As long as the de-listing takes place well before the reputation of the bank has tanked among investors, this is likely to provide a second life for these institution in due course. But damaged reputations are not salvaged by nationalisation, as can be seen in Iceland and in the case of Fortis.

*Appropriate products*. The third item is the most obvious but curiously enough least mentioned characteristic. With a nod to the food industry, we can say that all banking products are poisonous: what matters is the quantity in which it is taken.

Banks can not just change their size, geography or home market, but they all have a fundamental choice in the question of which products they trade. This is the real upside of the free market and it is amazing how herd behaviour seems to have clouded this principle and has lead banks to believe they had to "dance as long as the music was playing". Banks that did not join in the fun from the start made a judicious choice which was open to all.

**3. What is the likely *long term* response of regulators?**

Regulators will need time to adjust to the post 'cheap-credit' world. In the short term, regulation will be more of the same, but in the long term regulators can be expected to force the banks to behave like those that came out best in the current situation. This suggests the following

A. Tier 1 capital strengthening to double digit numbers
B. Limits on mark-to-market, especially in a rising market
C. Much greater transparency and accountability for off-balance sheet vehicles
D. Truly independent rating agencies
E. Executive pay, as well as dividend corrected for risk
F. Product review as an integral part of oversight

As a surprise consequence, regulation is likely to become less principle based. This may lead to a revamp for Basel II that does more damage than good. As a counter force in favour of principle based approaches, the proposed rating and valuation models (such as VaR) have lost much if not all of their shine. It is probably the most fundamental issue at stake and it is not clear how this will play out.

**4. What can risk managers do improve durability for their firms?**

A noted Dutch chess player commented: "A good chess player never suddenly sees a good move." This is also true for risk managers. The task for risk managers now is to hammer home the fundamentals of risk management and to anticipate the next level of requirements for successful banks. Four of these fundamentals bear repeating these hectic days:

A. All management levels are responsible and accountable for their risk position
B. This risk position must be reported, reviewed and made explicit regularly
C. New products and processes require additional monitoring and accountability
D. Risk positions are never captured in fixed models or simple statistics but must be qualified by stating all underlying assumptions.