

Welcome address and Big Issue debate 1

Financial systemic risk – the shockwaves continue. What next?

Monday 15 September – 14:00-15:30

Crisis demands fresh approach to risk

Financial crisis caused by risk failure at senior levels

Only a full-scale reappraisal of risk management and an overhaul of capital adequacy regulation can prevent future banking crises, delegates were told yesterday in the first of Sibos 2008's Big Issue debates.

Bill Rhodes, senior vice chairman, Citi, and David Hodgkinson, group chief operating officer, HSBC, both called for banks to institute independent risk management functions.

"Management must be tough enough not to get into new areas until they fully understand them," said Hodgkinson during the panel discussion, 'Financial system risk – the shockwaves continue. What next?' "And it is absolutely the responsibility of top management to maintain the balance between risk and reward," he said.

"The chief risk officer must have access to the board and report to the CEO," said Citi's Rhodes. "We must also have adequate capital reserves. The old saying goes 'Liquidity kills banks'. At times like these, it's important to have first, second and third line of defence in terms of liquidity."

Still digesting the overnight news of Lehman Brothers' Chapter 11 bankruptcy protection filing and the hasty alliance between Merrill Lynch and Bank of America, Sibos delegates were offered a smorgasbord of causes of the crisis that has spread from the US sub-prime loans market across the global financial system, and were then presented with a shopping list of remedies.

What went wrong? Pretty much everything, summarised moderator Martin Wolf, the chief economics editor of the Financial Times, after the panel listed inadequate regulation, reckless monetary policy, failure to understand or price risk, excessive compensation packages, shareholder pressure and mis-selling among the 'parents' of the current financial crisis.

Who's to blame? "Policy makers and regulators are perhaps responsible for about half of the problem, but the banks that



"The leveraged investment banking model is broken."

David Hodgkinson, group chief operating officer, HSBC

rushed lemming-like after risk spreads are at least as guilty," said Professor Willem Buiter of the London School of Economics. A former member of the Bank of England's monetary policy committee, Buiter also pointed the finger at financial regulators for continuing to act on a national rather than global level. "By allowing competitive regulatory arbitrage, they created a soft-touch environment in which names, rather than risks, were regulated," he said.

What next?

What should banks and regulators do now? Buiter said that only a coordinated global regulatory effort could address the excessive leverage of global financial institutions. "At

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continued



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Gertrude Tumpel-Gugerell, European Central Bank

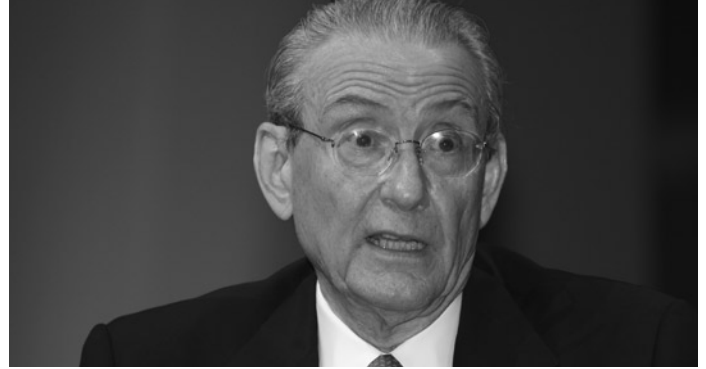
the very least, this requires more coordination between the EU and US, but it also increasingly needs the involvement of fast-developing economies such as China and India," he said. Buiter also proposed significant revision to how banks' capital adequacy levels are calculated under Basel II. As well recommending that off-balance sheet liabilities attract the same level of regulatory capital as on-balance sheet items, Buiter dismissed the use of internal ratings models as a "wholly conflicted and pro-cyclical notion." Marking to market – a least-worst option, according to Buiter – would need to be offset by making capital adequacy ratios counter-cyclical.

Rhodes also called for a concerted move toward international accounting standards and "international regulatory norms". Gertrude Tumpel-Gugerell, member of the executive board, European Central Bank, said the regulators and central bankers tried to maintain the balance of the financial markets. "We don't want to return to a completely regulated market because of the need to allow innovation. It might be unpopular, but banks need to listen to the regulators when the times



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are good," she said.

And the investment banks themselves? A better understanding of risk at all levels and a return to simpler, more transparent financial instruments and processes would be a good place to start. "When you're in a hole the first thing to do is stop digging. But that's not enough in this case. You need to be proactive," said HSBC's Hodgkinson. "The leveraged investment banking model is broken. Capital and funding weaknesses must be overcome. Leverage must be reduced and credit risks must be priced properly."

Securitisation was vital to the future of the industry, predicted Hodgkinson, as a means of distributing risk. But the taking of significant levels of proprietary risk onto investment banks' balance sheet would have to come to an end. "To return to normal, asset prices will have to be deemed to be stable with some downside risk. Simplify and standardise will be the key themes going forward," he said.

In terms of risk management, stress-testing and quantitative evaluation had been found wanting due to the interdependent nature of risk. Even if some banks had an accurate picture of their own exposure to the sub-prime market, "Few understood how big the problem was from an industry-wide perspective," Hodgkinson said.

Rhodes agreed with Wolf that compensation packages at investment banks had rewarded higher-than-acceptable risk-taking behaviours. "It's one element, but not the most important," said Rhodes, who added that the forthcoming report on compensation at investment banks by a G-30 committee headed by ex-Federal Reserve head Paul Volcker would "pull no punches". The ability of financial institutions to scale up "infinitely" in a bullish market made them "inherently unstable", said Buiter. "There's something wrong when the CEO can lead a bank into the swamp, then get paid \$100m when he leaves."

Finally, the big one. Is the worst over? "You must be joking," said Wolf. <<