



13th Southern African Internal Audit Conference

MEETING INCREASING EXPECTATIONS IN VOLATILE TIMES

16 - 18 August 2010 • Sandton Convention Centre

Risk Management: Lessons learnt from the global financial crisis

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Risk Management

Introduction

Purpose of the presentation:

- To understand the **global financial crisis**
- To consider the **impact on South Africa**
- To contemplate the **core risk governance failings**

To leave you with **4 key question areas** that you should ask your organisation about its true level of risk governance

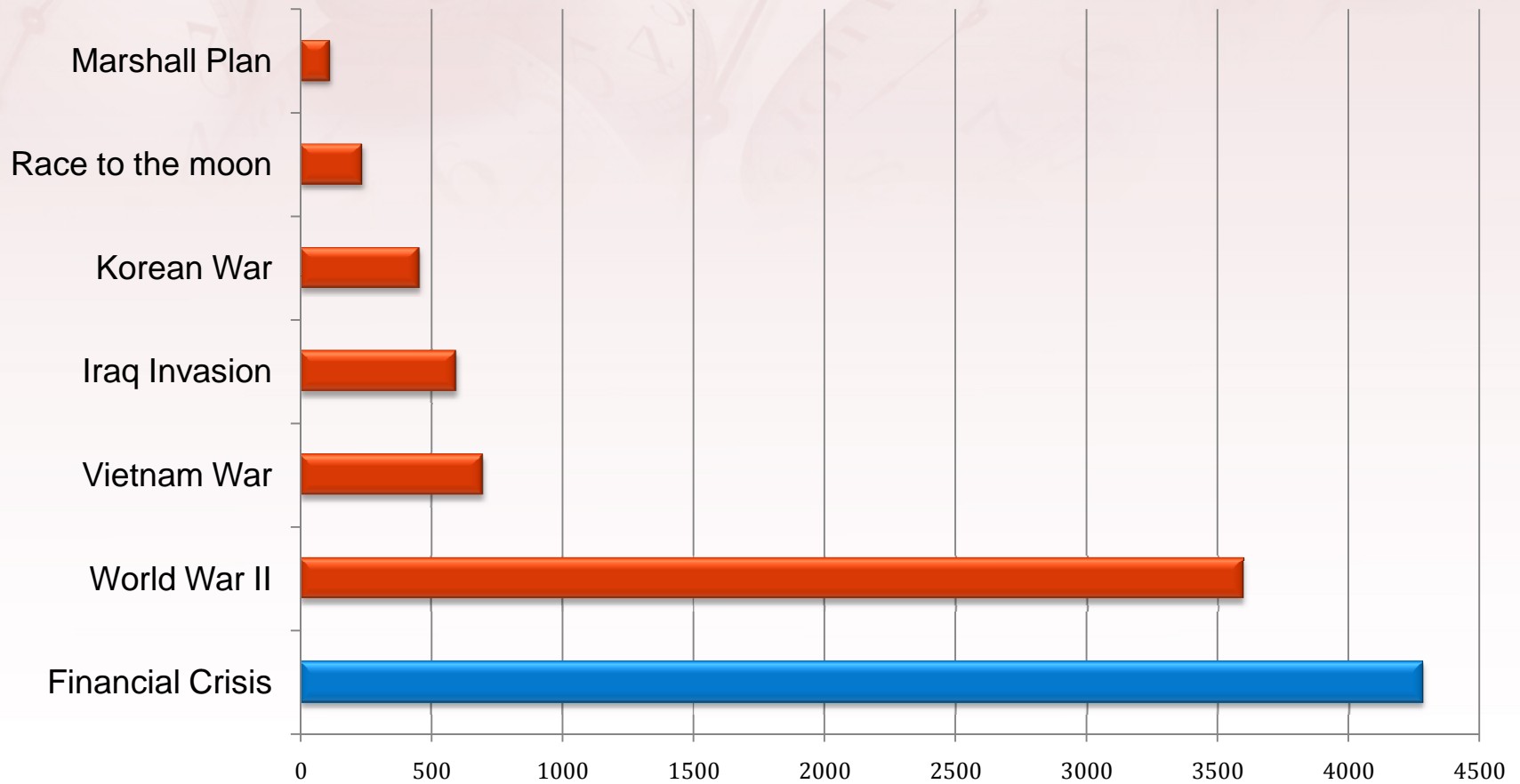


Understanding the global financial crisis

What went wrong?

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USD 4 280 000 000 000



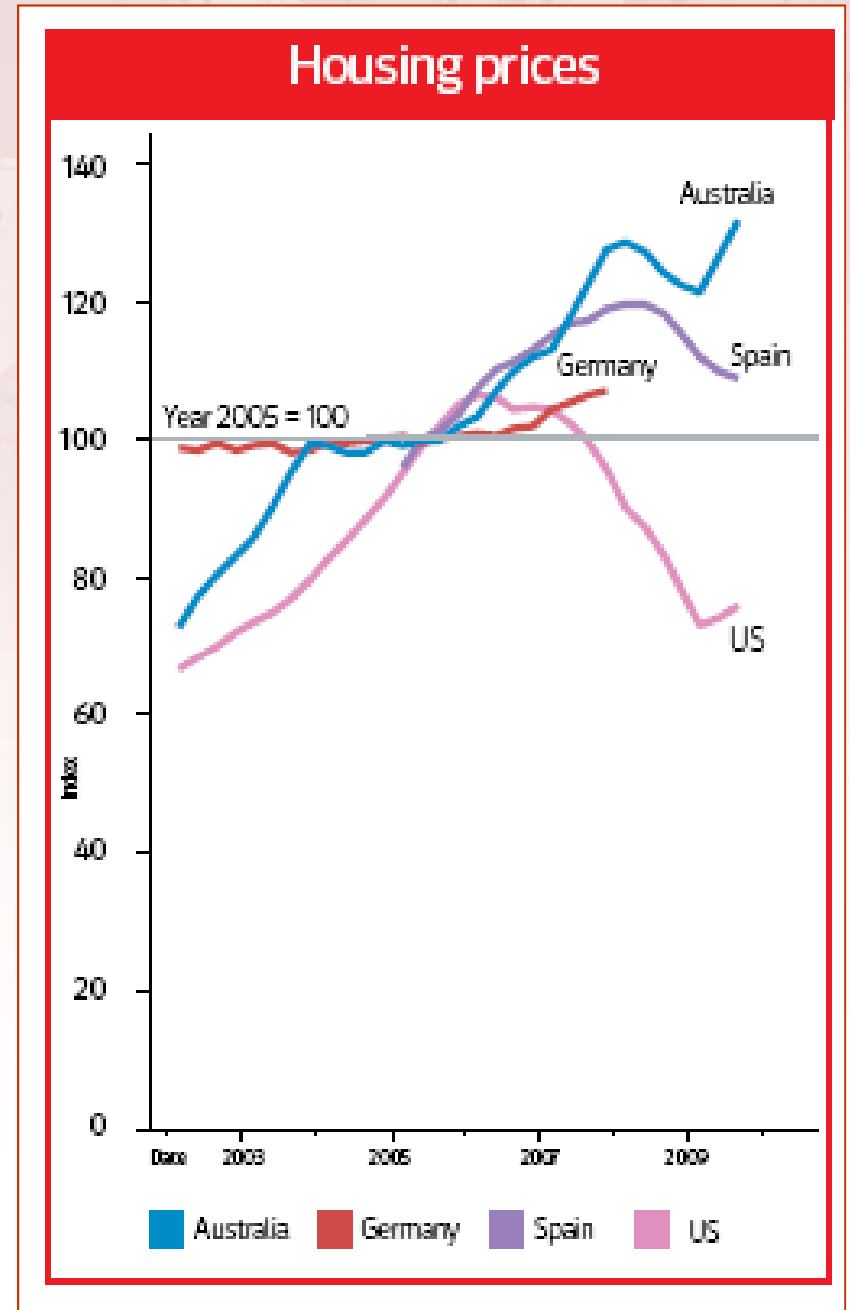
Inflationary adjusted cost in billions of USD

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What happened?

- Government pressure
- Low to moderate income household lending
- CDO and MBS sold for immediate returns
- Risk limited in bull market
- Bear market ensues
- Decreased property value
- Interest rate increases
- Increased defaults
- Negative equity

Source: OECD Observer



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What happened? (Continued)

- Excessive volume of securitized loans
- Bank take positions by buying securities from other banks
- CDO/MBS investor losses make instrument undesirable
- Investors in banks withdraw equity
- Bank depositors withdraw cash
- Solvency and liquidity problems ensue

Business Rescue (Troubled Asset Relief Programme “TARP”)

- Government cash injections and purchase of bank equity
- Government reduced interest rates and guaranteed deposits

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What happened? (Continued)




World's Top 15 Banks market capitalisation:

- 2007 – USD 1.7 trillion
- 2009 – USD 500 billion

“USD 25 trillion in asset values has been wiped out at the global level”

Source: *The global economic crisis and its impact on South Africa and the country's mining industry*
Roger Baxter



The impact of the global financial crisis on South Africa

Did the crisis hurt South Africa?

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Did the crisis hurt South Africa?

- SA only 1% of global GDP (lower counterparty risk)
- SA reliance on foreign trade and foreign investment
- Caused a recession in:
 - Mining
 - Construction and Manufacturing
 - Retail
 - Automotive
- “South Africa’s economy has initially weathered the global storm relatively well”

Source: The global economic crisis and its impact on
South Africa and the country’s mining industry

Author: Roger Baxter

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Did the crisis hurt South Africa? (Continued)

- Significant crisis induced movements in South Africa:
 - End second Quarter 2009 – 475 000 jobs lost
 - 73% of jobs lost in Construction and Manufacturing sector
 - 2 643 small to medium sized companies liquidated in first 8 months
 - 30% increase in liquidation on previous year
 - Finance, business service and real estate sector reported 40% increase in liquidations
 - Manufacturing sector reported 37% increase in liquidations

Source: Lumkile Mondi, Chief Economist, Industrial Development Corporation
The Annual SMME Conference, 15 October 2009, Cape Town, South Africa

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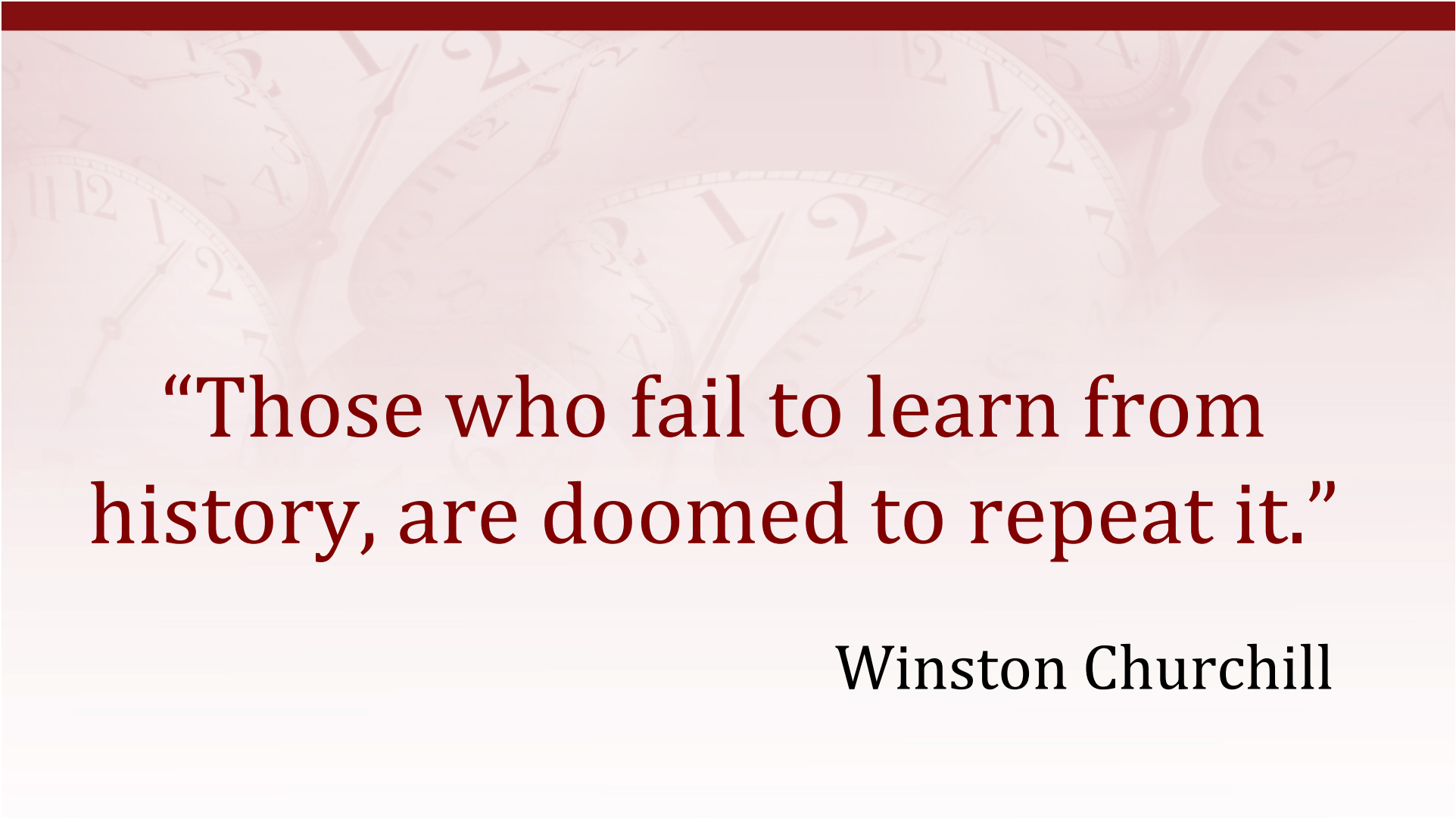
Did the crisis hurt South Africa? (Continued)

- SA organisation's adopt survival strategies:
 - Down sizing / right sizing
 - Recruitment freezes
 - Cost cutting initiatives
 - Acceptance of lower margin returns
 - Exploration of alternative markets and products/services
 - Delayed significant expenditure



The core risk governance failings in the financial crisis

The core failings



**“Those who fail to learn from
history, are doomed to repeat it.”**

Winston Churchill

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Core risk governance failings

Opinions on the financial crisis:

- It could have been a lot worse for South Africa
- South Africa survived more by luck than design
- South Africa needed the crisis to sharpen its risk governance
- There will be another financial crisis in the future
- The evolution of governance occurs after a crisis

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Core risk governance failings

The Board and Executive functions:

- Lack of *qualified* board oversight
- Failure to *revise earnings expectations* in downturn
- Failure to appropriately price risk
- Remuneration aligned to *short term profitability*
- Incentive structures not balancing *stakeholder* interests
- Lack of understanding of risks associated with instruments

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Core risk governance failings

Risk Management failings:

- Failure in *transmission* of risk information (silos)
- *Timeliness* of risk reporting and resultant action
- Lack of understanding of risks associated with instruments
- Deficiencies in stress testing *analysis assumptions*
- Over-reliance on incorrect/non-comprehensive assumptions
- Lack of understanding of risks associated with instruments
- Warnings for *liquidity risk were ignored*

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Core risk governance failings

Other factors:

- Failure of internal assurance mechanisms
- *Regulation not matching financial instrument* development
- Not anticipating the effect of:
 - Interest rate increases
 - Slump in the housing market
- False sense of security in presence of ERM framework



Is your organisation crisis proofed?

4 key factors in crisis proofing
your organisation

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Is your organisation crisis proofed?

- A number of the areas covered in this topic are directly related to financial services and specifically banking
- The following 4 crisis proof points are not specific to banking and should be present in all organisation's regardless of sector focus

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4 Crisis proof points

1

Executive Remuneration

- As a function of revenue/profitability only?
- With consideration of the management of risk?
- Executive incentive payments/exercise dates are longer term?
- Do Executive KPIs consider the balanced needs of all stakeholders?

2

Governance

- Appropriate composition of governance structures?
- Appropriately experienced personnel and members?
- Strategy and risk truly aligned?
- Quarterly meetings or integral governance assets?
- Aligned to the King Code/governance better practice?

“Good governance also *helps companies to weather the severe consequences of an economic downturn* with more equilibrium, as the results during the current global financial crisis show”

“invested more in corporate governance policies and practices, have produced substantially better operational and market results than their Latin American peers. *This is reflected in higher levels of profitability, relative share prices and liquidity, and reduced cost of capital*”

Source: International Finance Corporation – World Bank Group

Title: Chapter 7 – The Tangible Benefits of Good Governance

Date: 2008

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4 Crisis proof points

3

Risk Consciousness

- Functional Enterprise Risk Management implementation?
- Culturally embedded risk consciousness?
- Do management subscribed to risk management?
- Have you “sold” risk management to the business?
- Do they willingly participate and drive risk activities?

4

Risk Framework

- Board receiving a holistic picture of risk?
- Are risk reporting activities comprehensive and timely?
- How much is your organisation cognitively will to accept (appetite)?
- How much can your organisation take (tolerance)?
- Adequately managing external risk (eg. FOREX, Interest rate risk etc)?

“What they discovered was that in December 2006, Goldman’s various indicators, including *VaR and other risk models, began suggesting that something was wrong. Not hugely wrong, mind you, but wrong enough to warrant a closer look.*

“We look at the P&L. of our businesses every day,” said Goldman’s CFO, David Viniar (VIN-EEER) ... ‘We have lots of models here that are important, but none are more important than the P&L, and we check every day to make sure our *P&L. is consistent with where our risk models* say it should be. *In December our mortgage business lost money for 10 days in a row. It wasn’t a lot of money, but by the 10th day we thought that we should sit down and talk about it.*”

So Goldman called a meeting of about *15 people, including several risk managers and the senior people on the various trading desks.* They examined a thick report that included every trading position the firm held. For the next three hours, they pored over everything. They examined their VaR numbers and their other risk models. They talked about how the mortgage-backed securities market “felt.”

“Our guys said that it felt like it was going to get worse before it got better,” Viniar recalled. *“So we made a decision: let’s get closer to home.”*

This is true ERM.

*Source: Marsh Mercer Kroll Guy Carpenter Wyman MMC
New York Times Extract*

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Your organisation?

- Risk management will not prevent financial crisis but rather mitigates the extent of the outcomes to a likely survival position
- Recipe for sustainable business?
 - Good and timely risk information
 - Senior oversight/trend analysis
 - Risk and Operation personnel in concert
 - Management dedicate time to risk activities
 - Balanced reliance on risk models and “feel”

Is this the risk landscape in your organisation?



Questions?