



Red sky in the morning: the outlook for the economy and the financial sector continues to be mixed

Navigating risk

Participants in the UBS Cash Seminar consider sources of systemic hazards and offer possible solutions

“**Systemic risk** is like the Loch Ness monster,” said a speaker at the recent UBS Cash Seminar in Switzerland, “Hard to spot, until it rises up and bites you.” The remark struck a chord with the audience of bankers from 22 European and Asian institutions. While nothing untoward lurked under the placid waters of Switzerland’s Lake Thun, the scenic backdrop to this annual conference, few delegates were ready to let down their guard. In mid-2009, risk is still a very unquiet topic.

The turbulent waters of international finance and, most importantly, how to ply them provided the seminar with its main focus. Indeed, navigational failures take much of the blame for the industry’s woes, said Hays Littlejohn, UBS’s head of global cash solutions, in his introductory remarks. A major weakness was the overdependence on incomplete risk models. “It’s fatal to confuse the map with the terrain,” added Littlejohn, a keen (and safe) hiker in his spare time.

How can bankers raise their game? The seminar was long on proposals. Darryll Hendricks had flown the Atlantic to explain how UBS has tightened up risk management. A former staffer at the New York Federal Reserve and now UBS Investment Bank’s head of risk methodology management, Hendricks outlined the bank’s comprehensive risk management and control

renewal programme. These measures, he explained, go beyond risk, finance and treasury functions to address management remuneration and incentives.

Other initiatives concentrate on the nitty-gritty of risk control. Several are designed to ensure that transactions can be consistently and efficiently reconciled and that risk is more accurately represented. Stress-testing will increasingly be linked to credible macro-economic scenarios and reinforced by so-called reverse stress-testing, which seeks to answer the question “what events could cause us to lose this amount?” The overriding purpose is to match the map more closely to the terrain.

It fell to UBS Investment Bank’s Andrea Melchior to provide a credit perspective. The challenge of managing risk during a systemic crisis, he said, lay in separating fact from rumour, and real risk from negative sentiment. For this reason, risk controllers need to keep their doors open to information from operations departments and the front desks. It’s vital, he added, to understand what your counterparty is actually doing and to ensure that collateral agreements are tightly drafted.

Not all systemic risks have run riot during the latest banking crisis. If not entirely vanquished, settlement risks have been kept well under control. Much of the credit for the smooth operation of the

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foreign exchange markets during the past year accrues to the CLS Group, which settles currencies that account for some 95% of global trading. Jonathan Butterfield, the organization's communications head, provided an overview of past achievements and future possibilities (see separate article on page 4).

There are some hazards, however, that not even CLS membership can mitigate. When trading in the Icelandic króna was suspended in October 2008, banks with positions and client accounts in that non-CLS currency faced an entirely new situation. Indeed, operations professionals are still digesting the lessons. Delegates to the Cash Seminar took the opportunity to exchange experiences in group break-out sessions.

"When the ISK went down, absolutely nothing was clear," reported Jean-Pierre Doerig, UBS's head of client servicing, echoing the experience of many other bankers. At UBS, he continued, the operations teams needed two to three days to get a fully accurate picture of exposures. A further challenge was organizational. "We had to establish who had to speak to whom," Doerig said. Key operations, legal, and front-desk representatives formed a task force that, initially at least, held hourly conference calls. The top priority was to keep clients informed.

ISK management

Further reflections on the ISK experience came from Bill Boss, UBS's global head of FX and money market operations. When every bank was scrambling to unwind positions, the transparency and assurance afforded by the CLS system would have been a huge advantage, he said in a presentation on operational excellence. Outside CLS, Herstatt risk is still difficult to manage within standard guidelines, he added. Creative thinking is needed to arrive at intermediate settlement solutions between the extremes of CLS and "safe

settlement" on a delivery-versus-payment basis.

Compliance risks are less amenable than settlement exposures to technical solutions. But they deserve equal attention. As UBS compliance specialist Patricia Sullivan pointed out in a presentation on anti-money laundering (AML) strategies, any bank that transacts in US dollars puts itself within reach of American prosecutors. And the scope for compliance breaches is growing by the year, she noted.

The Patriot Act, for example, extended the obligation to report suspicious account activity to additional types of financial institution, including certain segments of the securities and futures industry.

To identify the origin of a suspicious transaction, institutions depend on the originating bank to "know its customer" thoroughly. To improve transaction transparency, SWIFT, at the suggestion of the Wolfsberg Group of banks, will introduce a new message format for cover payments in November 2009. MT202 COV will include underlying customer credit transfer details, as well as basic payment and routing information. UBS will adopt the new format at its launch date.

No discussion of systemic risk would be complete without a tour of the economic horizon. That perspective was provided by Daniel Kalt from UBS Wealth Management's research unit. With the US aiming to triple its monetary base by the end of

this year, we are all participating in an unprecedented macroeconomic experiment, he pointed out. While Japan was able to mop up surplus liquidity quite swiftly after its own quantitative easing phase in the early 2000s, the US may find it hard to follow suit, Kalt suggests. That is because the Bank of Japan invested in highly liquid treasuries – which could easily be sold back into the market – whereas the Fed has bought up very illiquid and difficult-to-price problem assets.

If this scenario is correct, inflation poses a serious long-term threat. Indeed, rising public-sector debt will provide governments with an additional incentive to let inflation rip. At the same time, stricter regulation of the financial sector will tend to crimp lending and keep corporate earnings in check. A re-run of 1970s-style stagflation, to say nothing of a second downward lurch into a double-dip recession, cannot be ruled out.

Unruffled by this dire prognosis, Lake Thun preserved its mirror-like calm for the full two days of the conference. Overhead, however, clouds started to gather. Like Dr Kalt's economic forecast, the weather outlook was distinctly mixed.

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Cash seminar: industry insights combined with interbank networking

