

Another dimension to risk for financial institutions

By Jonathan Shih and Rupert Jolley, UBS AG

In recent years, financial institutions have experienced a sustained increase in regulation and litigation. This should neither be regarded as an unnecessary evil, nor should it come as a complete surprise given the rapid evolution of financial markets. Indeed, regulation, when carefully considered and clearly implemented, can help rather than hinder financial markets. Even litigation and subsequent judgements can refine legal interpretation and add definition to the parameters of acceptable business practice. The challenge for financial institutions is to grow whilst complying with rapidly evolving regulations, avoiding litigation wherever possible, and to do so in a forward-looking manner.

There are two macro risks which financial institutions face in this regard. The first is driven by the dynamic nature of financial markets, which help to shape the evolution of products and business practice. The danger inherent is that both products and business practice can out-pace existing regulations and cause financial institutions to conduct business in “uncharted” waters. The second risk is that financial institutions may be caught unaware if there is a paradigm shift in the standards of conduct expected of them. These standards are generated both informally by the socio-political environment and by regulation which often formalises socio-political expectations. Such paradigm shifts can cause business to be brought to a halt until practice adapts to the new regulations, or worse a financial institution allows business to continue without accommodating the new regulatory environment.

Both these risks, if they crystallise, can build up a legacy liability for a financial institution. The concept and practice of regulatory, legal and ethical risk assessment is borne from the realisation that financial institutions need to monitor an evolving environment, predict and actively prepare for future regulation and litigation risks.

WHAT IS REGULATORY, LEGAL AND ETHICAL RISK?

Deriving an all-encompassing definition of regulatory, legal and ethical (RLE) risk presents a challenge due to the fluid nature of the drivers of the risk, namely regulations, laws and ethics. The consequences, however, are clear and can include financial loss resulting from

regulatory fines or penalties incurred by not adhering to applicable laws, regulations, accounting standards, or internal standards as well as the non-enforceability of contractual rights.

Whilst financial institutions are in the business of taking risks, RLE risk is not in the same category as credit or market risk. Instead, RLE risk can be regarded as a risk that is coincidental rather than deliberately entered into by a financial institution, and as such the aim is to ideally remove it. However, risk removal is not always possible and instead risk mitigation in the form of risk awareness and management is often the pragmatic approach to adopt.

EXTERNAL RISK INDICATORS

The objective is to establish a methodology that identifies shifts in industry practices and analyses these shifts in the context of often loosely articulated societal expectations. There are two generic types of risk indicator, “external” and “internal”, as shown in Figure 1.

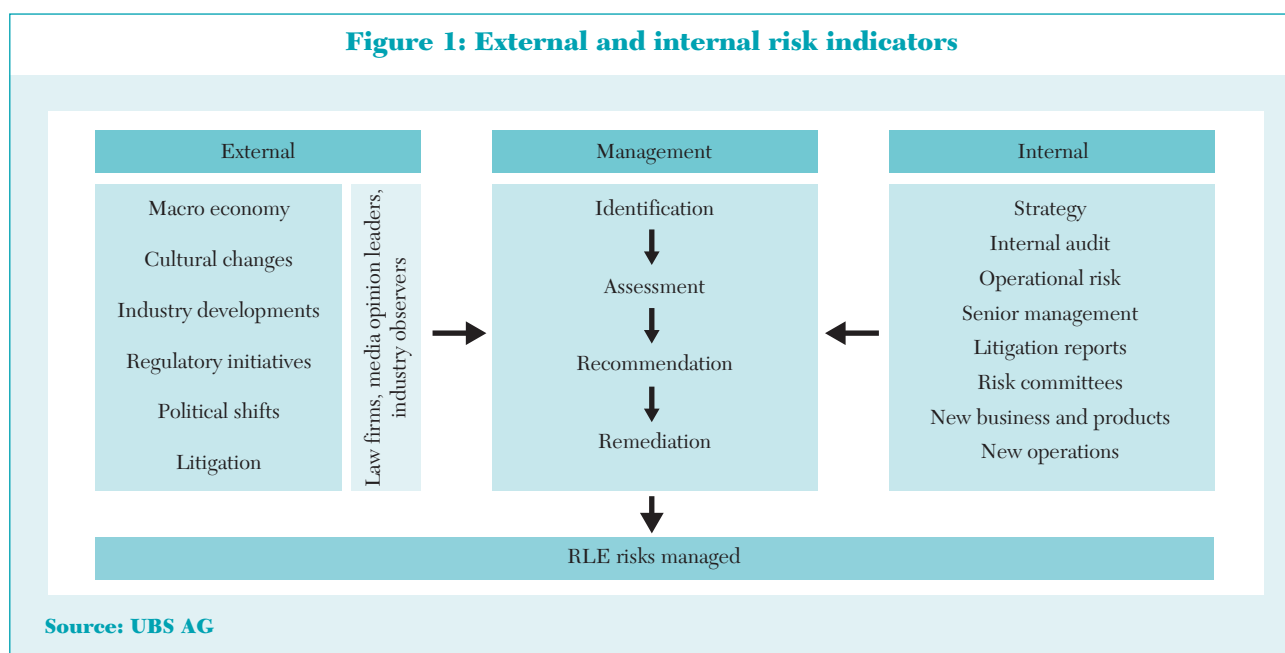
A financial institution has first to identify external risk indicators and to make sense of them in order to determine business activities that may be subject to RLE risk. Certain of those risk indicators are relatively tangible whereas others are intangible.

Prima facie, legal and regulatory changes are amongst the most tangible indicators of legal and compliance risk. Such changes can take time to emerge but they can also occur suddenly in response to economic or social political pressures, and once they occur can reach far across the businesses and geographies in which a financial institution operates. The spate of corporate scandals in the US leading to Sarbanes Oxley in 2002 provides an obvious example of such legislation.

In a world where economics, politics and law are increasingly inter-dependent, assessing risk that is driven by external factors such as the macro economy, industry developments, cultural changes, regulatory initiatives and litigation requires complex analysis and synthesis. To take one example, how should a financial institution interpret the growth of hedge funds from the perspective of RLE risk?

Should they perceive the possibility of a bubble, which if it bursts presents hedge fund counterparties as a risk? Should they consider the acceptance and growth of hedge funds as a possible cue to provide

Figure 1: External and internal risk indicators



access to hedge funds for their clients who seek these investments, in which case the attendant requirement is to ensure the suitability of the investments? Should they recognise the opportunity that hedge funds present as clients and grow their prime brokerage services accordingly, managing the growth of this business with the concomitant regulatory requirements? Should a financial institution consider setting up a hedge fund itself whilst recognising the need to avoid conflicts of interest with its existing business?

The answer is probably “yes” to all these considerations and therein lies the challenge, since financial institutions do not operate in a vacuum as they respond to clients' demands and try to deliver growth for shareholders. Hence, financial institutions in their day to day business activities “reveal” RLE risk through internal risk indicators.

INTERNAL RISK INDICATORS

Certain internal risk indicators can be considered as lagging because they indicate risks that are already present. Reports concerning pending litigation against a financial institution provide a good example. Litigation can suggest that a financial institution has acted incorrectly and hence a risk has “crystallised”, although clearly this need not necessarily be the case. Even when a risk crystallises the ultimate loss can remain latent before becoming actual when realised. Indeed, a financial institution may never fully “realise” the extent of a loss that may cause damage to its reputation and brand.

Another internal risk indicator is provided by internal audit reports, which highlight areas where a financial institution may be

running risks in its daily operations. Often the risks have not yet crystallised, and the opportunity to correct practice in order to remove risk is still available. As such, the indicator can be regarded as a leading one, which is particularly helpful when strategically assessing risk.

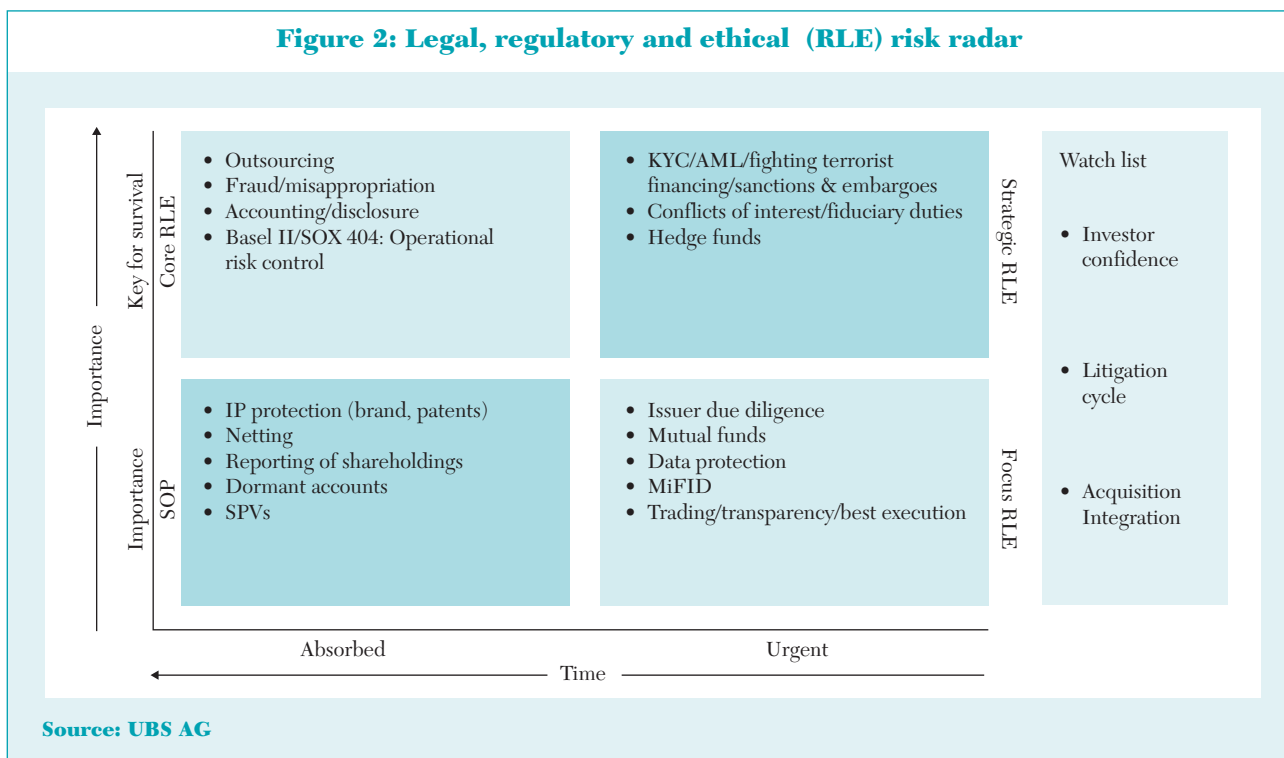
The formal review of new business proposals before a financial institution enters into transactions or new business areas is also a means of assessing RLE risk ex ante. Once approved, new businesses also require careful and regular monitoring in order to ensure that unnecessary risks are not incurred as the products evolve beyond their initial constraints or client segments. The evolution of structured products is a case in point.

A REGULATORY, LEGAL AND ETHICAL (RLE) RISK RADAR

Having identified indicators of RLE risk, a financial institution should focus on those risks that pose the greatest threat. Identifying such risks requires a holistic overview of the organisation and the judgement to spot near misses or small loss events that, if addressed early, could eliminate more systematic risk. At UBS, a “Risk Radar” has been developed for the purpose of developing a strategic view of emerging risks with the objective of addressing them in good time (see Figure 2). The model is regularly updated as risks are absorbed and as new risks emerge.¹

The model suggests that certain risks require a financial institution's immediate attention, being critical for survival, whereas others can be addressed in a more considered way, and may need to be as regulators' approaches towards them remain uncertain.

Figure 2: Legal, regulatory and ethical (RLE) risk radar



Changes in a financial institution's practices may also take time to plan and implement. Ultimately, the aim is to remove or manage risk before it results in litigation, regulatory sanctions or damage to reputation.

The model is dynamic, such that a risk may enter it in any of the boxes, and during the 'life cycle' through which a risk is managed it may move into different boxes before ideally being removed from the model altogether. One strength of the Risk Radar is that whilst its primary audience is senior management, all layers of the financial institution can apply the model and populate it with perceived risks relevant to their business.

Active RLE Risk Assessment in a financial institution reinforces an organisational culture that is risk aware, seeking to avoid risk or to at least manage it if avoidance is not possible. "Conflicts of interest" help to illustrate this point. There may be certain transactions where a financial institution should avoid risk altogether. For example in a hostile takeover, acting as adviser to both the target and bidder presents clear risks that most institutions will feel is best avoided by acting for only one of the parties. Risk is then further managed by enforcing Chinese walls in order to allow a financial institution to continue with its ongoing daily business, such as trading for clients and sometimes trading on a proprietary basis.

COLLECTIVE RISK ASSESSMENT

The internal avoidance and management of risk by any one financial institution is important for the efficient functioning of the financial system as a whole. This forms a rationale behind the recent "Strategic Dialogue on Effective Regulation" initiative by the Institute of International Finance (IIF). The initiative intends to present the concerns of financial institutions and propose constructive approaches for addressing them in collaboration with the regulatory community.³

Both financial institutions and regulators have a shared interest in avoiding regulations that are excessively complex to implement and that may not be sufficiently flexible in order to evolve together with the financial system. As the industry globalises it is also important that regulators co-ordinate amongst themselves in order to ensure a level playing field for financial institutions as they seek to service clients innovatively.

In effect, risk assessment, avoidance and management are increasingly collective in nature, reflecting systemic risk and the challenges facing the industry as a whole. The approach taken towards solving the backlog in credit derivative confirmations by major industry participants in late 2005 is illustrative. An estimated US\$12bn of outstanding contracts was identified and major credit derivatives market participants came together with a plan to automate processing and move towards cash settlement.

NO PANACEA BUT PHILOSOPHY

There is no panacea for a financial institution when confronting RLE risk whose evolution is, by its nature, rapid and difficult to predict. However, there is arguably significant competitive advantage to be obtained in adopting a philosophy that seeks to engage in rigorous assessment of risk so that particular risks can be foreseen and managed.

Given that a considerable part of the rationale behind regulations is the reduction or management of risk for the financial industry as a whole, there is also further scope for financial institutions to work together with regulators when assessing risks. In this way regulations are derived which are predictable, capable of being implemented and thus not risks per se but solutions thereto.

Notes:

- ¹ Mainsprings of Financial Services Regulations – Towards a Dynamic Model of Understanding Changes in Legal, Regulatory and Ethical Risks of the Financial Services Industry. Peter Kurer, Group General Counsel, UBS AG. 2005
- ² See www.IIF.com for further information concerning the IIF and initiative.

**This article was written by Jonathan Shih and Rupert Jolley, Group Legal and Compliance Risk Assessment, UBS AG, P.O. Box CH-8098, Zurich, Switzerland.
Email: jonathan.shih@ubs.com, rupert.jolley@ubs.com
Web: www.ubs.com/b4b**