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Managing Banking Risks in Australian and Chinese Banking Systems:
Credit and Operational Risks: Observations on Lessons from the past year

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The turbulence of the past 12 months in financial markets has demonstrated a number of shortcomings in credit and operational risk management practices. These shortcomings, however, do not necessarily reflect new or unknown risks that have emerged in recent times. Rather, in many cases they reflect long-standing lessons that many financial market participants now wish they had not forgotten.

1. ***Asset prices do not always rise.*** Numerous financial products and business structures utilised over the past decade have been developed (not always knowingly) on the assumption of continually rising asset prices. The sub-prime mortgage market in the US has been the most recent and obvious case. History shows – 1980's equity prices, 1990's commercial property prices, early 2000 tech stocks - that this is a fatally flawed assumption.

2. ***The conceptual benefits of the originate-to-distribute model did not always eventuate in practice.*** The premise of the originate-to-distribute model was that risk would be passed to those best placed and most willing to hold it. In practice, the degree of separation and complexity in the process between those originating assets and those eventually holding them, meant that the end investors had little way of knowing what risk they actually held, and hence whether their returns were adequate for the risk being carried.

3. ***Outsourcing credit analysis is fundamentally bad practice***. Too many investors (including banks) have effectively outsourced aspects of their credit analysis to the rating agencies. Particularly for structured credit products, investors relied too heavily of the 'AAA' stamp of the rating agencies, without fully understanding the underlying risk profile of the investment they were making.

4. ***Correlations are not always low/stable***. In prosperous times, risk managers can rely on a relatively low and stable correlation between credit events – in other words, a healthy

degree of diversification can be relied upon to protect against material loss. In times of stress, however, these correlations rise and the diversification benefits reduce. Examples include:

- the probability of default and the loss given default will tend to rise together in times of general stress;
- the creditworthiness of credit protection providers will deteriorate at the same time as there is a general deterioration in credit quality; and
- financially independent counterparties with general business relationships may become financially dependent in times of stress.

5. ***Back-to-back/arbitrage trading is not risk free.*** Risk of often viewed on a net basis, but recent events have highlighted the importance of suitable limits to (and reporting of) gross exposure, in addition to net exposure. In many respects, this was also a lesson of the Soc Gen fraud.

6. ***Product complexity hides risks.*** There are numerous examples where conceptually simple products in fact have 'hidden traps' which are not understood or evident until times of stress. In boom times, these traps are never triggered, but in times of stress the investor can often find details in the fine print that act to their detriment.

7. ***Market disruptions increase the challenge of valuing illiquid products.*** Market closure or disruption can lead to substantial difficulties in the valuation process as market prices either become unavailable or buy/sell spreads extremely wide. Mark-to-model approaches may also become unstable as models are calibrated to more benign environments, and liquidity premia become significantly more important components of overall price determination. Recent events have highlighted the importance of a proper functioning and suitably independent valuation committee.

8. ***The distinction between trading and banking books is not 'set and forget'.*** Banking capital adequacy requirements make a distinction between trading book assets (those with liquid markets and held for trading purposes) and banking book assets (held on the balance sheet without trading intent). Importantly, capital requirements for the former are lower than for the latter, on the basis that it is easier to reduce a position and cut losses if the need arises. In times of stress, however, liquid markets may not exist, and banks may elect to hold assets to maturity rather than sell (or even just mark-to-market) at distressed market prices. In these circumstances, it is important that any capital adequacy concessions given to trading book assets are removed.

9. ***Banks have underinvested in risk systems generally, and find it hard to get critical credit risk data very quickly.*** With the complexity of credit products and a diversity of geographic locations, banks find it difficult to quickly get good exposure information when trying to compile direct, derivative, indirect, contingent and related party exposures to a given counterparty. In normal times, when time is not so critical, this need not be fatal, but in times of crisis when information is needed quickly, this can lead to having to make decisions based on incomplete information.