Article by CGF Research Institute & Riskflow

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Corporate governance in a turbulent economy - an integral component of ALM (Asset Liability Management) and risk management

International turbulence

The past 8 months have seen immense turbulence in the financial markets. All over the world, investors, corporates and individuals have been deeply shocked by the economic melt-down as the world recession becomes more evident. Large banks, such as Lehman Brothers, have disappeared from the landscape, whilst icons such as Royal Bank of Scotland (-28 Billion GBP in 2008) & AIG (-61.7 Billion USD in the last quarter) have announced massive losses and have required government bail-outs and huge assistance with their toxic assets. The stock markets have taken a brutal knock and literally trillions have been wiped off the balance sheets of the financial markets.

The realisation has dawned that this is no ordinary recession. In risk management, practitioners often look at the correlation effects of having problems in related industries and how they have a knock-on effect. The US faces a number of very difficult problems simultaneously. The property market is down 18% over the past 12 months. Interest rates have already been cut with the Fed funds rate now targeting 0-0.25%. The Federal debt/GDP ratio is already high and the Federal deficit (and that does not include the 50 states) is forecast at 12% of GDP for the 12 months to 30 September 2009.

Globalisation, the use of the Internet and derivative products have ensured that situations move quickly and the contagion effect is manifest everywhere. World leaders are gathering to create a unified approach to deal with the crisis. The magnitude of the global challenges have taken their toll on South Africa's exports and our local economy is starting to reel with a strong downturn in our manufacturing and mining sectors. The current global environment provides serious challenges for local treasury and forex operations and the associated risk management practices.

Risk management – What now?

In June 2004, the major international bankers, outside the US, signed the Basel II Agreement (also known as the Accord) which upgraded the original Basel Agreement of the Bank of International Settlements. The Basel II Agreement introduced stricter regulations as to how credit risk weightings would be calculated. There has been a great deal of pressure upon large banks to sign and comply with the Basel II Agreement. The existence of globalisation and the fact that the US never ratified Basel II created many loopholes. In particular, with the US having a "sophisticated" securitisations market and hence a highly over-leveraged market, the poor policing provided by the Basel II regulations created huge problems.

The Basel II Agreement has thus not been effective in protecting the global banking industry and treasury environments from liquidity, credit and debt crises. It is not only the credibility of Basel II that now lies in tatters. The major economies of the US, UK, Euro Zone and Japan are experiencing serious recessionary problems. The IMF (International Monetary Fund) traditionally set a guideline of budget deficits of 3% GDP, but the US is significantly higher than this and financiers are questioning the credibility of the IMF as well. Large Swiss banks such as UBS and Credit Suisse are starting to lose grounds vis-à-vis their credibility. The 20 largest banks in the US have been instructed by the Obama administration to undergo strict stress testing to test their viability under very adverse conditions. Investors are concerned about the safety of the US Treasuries and are questioning how the US will fund its debt?

Following this bleak summary, corporates have a tremendous fear that the institutions and cherished names in which they always placed their faith have been proved to be somewhat flawed. In a world where so many respected companies are facing bankruptcy threats, the word 'blue chip' now seems a complete misnomer.

Corporate risk management

Treasury departments in large corporates are being subjected to the same issues that banks face: forex, cash flow and credit defaults. Looking around the world they find themselves facing something of a void. On one hand there is a great need to align oneself to international risk management benchmarks, but many of these are either not credible or are archaic in nature. Accordingly, this situation creates difficult challenges, gaps and great concerns for management.

It may be argued that one of the perceived failures of Basel II was quite simply caused by Behavioural Risk. It was the risk of human beings behaving in a manner which was greedy and not in the long-term interests of the company. The simplest way to place checks and balances upon human behaviour is to have greater accountability and better governance processes set in place to manage risks across the entire company. It is a common problem to have a powerful CEO who overrides a quieter or subdued risk manager. The best risk management techniques in the world are of no value if they are not properly applied with the appropriate governance measures and controls in place, and supported throughout the company.

Moreover, a best practice Enterprise-wide Risk Management (ERM) system in a treasury department of a large corporate would probably need to manage the foreign exchange volatility through the use of cash flow forecasting and derivative products to hedge potential risks. Such an ERM system would also need to address, in detail, the cash flow forecasts which are derived from the various investment vehicles. Additionally, companies must consider the risks associated with interest rate fluctuations which should be analysed through 'stress testing' as well as projecting other movements in yield curves. Derivative products such as interest rate swaps can do a great deal to mitigate risks.

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About CGF Research Institute (Pty) Ltd

CGF specialises in conducting desktop research on Governance, Risk and Compliance (GRC) related topics. The company has developed numerous products that cover GRC reports designed to create a high-level awareness and understanding of issues impacting a CEO through to all employees of the organisation.

CGF's capabilities extend to management consulting, executive learning and facilitation of Corporate Governance and Risk awareness workshops, which caters for large corporates to small and medium sized businesses.

About Risk Flow (Pty) Ltd

Riskflow has been a pioneer in the development of Treasury-related software for nearly 20 years, particularly in the field of ALM and Treasury administration. Riskflow serves a wide range of high profile clients, both in South Africa and other African countries. Riskflow offers comprehensive solutions including: implementation of financial models, risk management consulting, training and on-going software support.

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