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ARAB BANKING CORPORATION (B.S.C.)

MANAGING RISK IN A RISKY WORLD: HOW TO MITIGATE KEY RISKS FACING FINANCIAL INSTITUTIONS IN THE MIDDLE EAST

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Outline

- Expanding Risk Management Focus
- Key Risks at Middle East Banks
- Risk Indicators and Metrics
- Economic Capital Allocation Proxies
- The Risk Profile Dashboard

I Expanding Risk Management Focus

- The new risk management paradigm goes beyond mitigating losses after incurring exposures, towards optimizing returns and maximising enterprise value up front, in the business planning process
- This means assessing value, at source, to prudently manage both qualitative growth (new products), and quantitative growth (new volumes)
- Consequently, communication and metrics are required at the macro level with the Board and Top Management, and the micro level with the Front Office

I Expanding Risk Management Focus (cont'd.)

- At Board level the nexus between Risk Strategy and Business Strategy is through a defined and measurable Risk Appetite, and Risk Tolerance
- This Appetite is set in tandem with the business planning and budgeting process, to predetermine risks to be incurred, prioritize them, and resource accordingly
- At the micro level, this requires clearly defined product (portfolio/process) risk parameters & metrics, to mitigate risks up front, and avoid costlier remedial action

Expanding Risk Management

Enterprise Wide Risk Management

Expanding Risk Management

- Risk appetite can be defined across numerous dimensions
- Some important ones are:
  - Desired external risk rating to be achieved (A, BBB, etc..), as this implies certain return volatility, liquidity, capital cushion, and asset quality parameters
  - Risk Adjusted Return On Capital threshold (RAROC hurdle rate)
  - Weighted average portfolio credit rating
  - Relative capital allocation to credit, market, and operational risk domains
  - Liquidity threshold
  - Asset & Liability tenor mismatch
  - Sector thresholds
  - Concentration thresholds

II Key Risks Facing Middle East Banks

- The overall range of risks is similar to that faced by non-ME banks, but the profile, in terms of quantum per risk. is different
- Prominent or key risks include:
  - Concentration Risks
  - Mismatch Risks
  - Business Cycle Risks (oil cycle, etc..)
  - Liquidity risks given shallow markets
  - Legal enforceability risks
  - Governance risks
  - Data quality driven model risks

II Key Risks Facing Mid-East Banks

- Lumpy non-granular portfolios
- Asset tenor profile lengthening vs. limited term liability products
- Oil income driven macro environment, and asset prices
- Liquidity contingences amidst crises
- Ever increasing earnings pressure on Top Management heightens governance risks (who assesses CRO, and determines bonus)
- Reporting to a Board Committee which balances between risk and business imperatives
- Data quality supporting metrics on credit, market, and operational risks
- Disaster recovery is also a key risk issue

III Key Risk Indicators & Metrics

- The common currency of risk is Economic Capital (EC)
- EC allows for comparison across risk types, and risk domains, per transaction, portfolio, and business unit
- EC alone can be misleading to prioritize risk management response
- Arriving at EC requires probability, severity, distribution and correlation for each risk domain
- Each of these elements is required to determine risk response
- For Credit Risk this is reflected in PD, LGD, EAD, EL, and volatility of EL to determine UL

III Key Risk Indicators & Metrics

- For Operational Risk: Probability of Event (PE), Loss Given Event (LGE), or Severity, and loss distributions per process
- For Market Risk: Return volatility, Average Returns, Return distribution, and Correlations
- In order to build robust and relevant capital models for each of these domains regional market specific data is required
- Until such time as these distributions become available, we can only sensitize risk indicators by using proxies or imperfect surrogates
- The risk response for a high probability – low severity process, is different from that of a low probability – high severity process

IV Economic Capital Allocation Proxies

- The closest proxies available are those relating to internal regulatory capital models out of Basel
- The reason they provide value over and above the current semi-qualitative metrics we use, is that they cover a wide range of environments from data intense markets such as the USA's, to relatively date shallow markets, such as Southern European countries
- I would suggest that this range of diversity entails building conservative models that make up for the idiosyncrasies of our markets (especially those of the GCC)

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The Risk Profile Dashboard

- A simplified example of a tool that can be used to prioritize for busy executives risk requiring action in various areas of the bank

	Area			
Risk	**Corporate**	**Retail**	**Treasury**	**Etc…**
Credit	**Red**	**Yellow**	**Green**	
Market	**Green**	**Yellow**	**Red**	
Operational	**Yellow**	**Red**	**Yellow**	
Etc..				

Red – High Risk; Yellow – Medium Risk; Green – Low Risk

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Thank you

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