



# Global Fallout from Credit Crunch

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# Agenda

1. Opening Remarks
2. Impact on Asset Management industry
  - (i) General
  - (ii) The Facts
3. Problems highlighted
  - (i) Categorising Risk
  - (ii) Risk Management Function
  - (iii) Identifying Risks
  - (iv) FSA and Risk
4. What to do – practical steps
  - (i) More Stringent Controls
  - (ii) TCF – Adequate Risk Management
  - (iii) Regulatory Impact
  - (iv) Responsibilities
  - (v) In-House Lawyer

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## 2. Impact on Asset Management Industry

(i) General:

- Not as severe as effects suffered by banking industry
- Unusually retail funds suffered outflows in this crunch

(ii) The Facts:

- **Equity funds:** Strong outflows with €12bn being redeemed in March and approximately 75bn in the first quarter (however, shareholders bought a net 16bn in equity based Exchange Traded funds in the same period).
- **Bond funds:** Worst selling asset class with continuous strong outflows amounting €14bn across all markets, the second largest monthly outflow on record.
- (see presentation)



## 3. Problems highlighted (i)

• Categorising risk:

- Credit risk
- Financial risk – includes credit risk, but also liquidity risk, market risk, FX risk, interest rate risk, counterparty risk and documentation risk
- Operational risk – all risks other than credit/financial risk – also known as non-financial risk – includes: legal risk, regulatory risk, and reputational risk



### 3. Problems highlighted (ii)

- Risk Management function
  - No need to have a separate function but may be advisable - v- external experts
  - Establish adequate risk analysis tools
  - The components:
    - Legal risk is a subset of risk - litigation risk, consider the additional financial loss and unnecessary distraction. Increasing threat of US style Class Actions
    - Proper legal due diligence
    - Counterparty risk – are you over-using one CP; if Bank A goes bust are you locked in?
    - Reputational risk – very difficult to undo damage
    - Employee risk – are they motivated, properly trained and following risk/compliance procedures. Education should be key part of Legal function

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### 3. Problems highlighted (iii)

- Identifying Risks
  - Each firm should identify the risks relevant to it
  - At a minimum:
    - A range of financial risks will be relevant
    - Operational risks will be relevant
    - Retail business to consider risks to customers
    - FSA's statutory objectives

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### 3. Problems highlighted (iv)

- FSA and risk
  - Risk is relevant under the FSA Handbook and as part of FSA supervision:
    - Risk assessment function
    - Capital/financial resources requirements
    - Adequate risk management systems
    - Treat Customers Fairly
    - ARROW assessments



### 4. What to do (i)

#### More Stringent controls:

- Legal reviews – (see slide page 12)
- Valuation process – discuss role of rating agencies
- Clarity in fund documentation, particularly in regard to investment objectives
- Use of derivatives – ensure traders are clear as to what is allowed



## 4. What to do (ii)

- TCF – adequate risk management systems/common sense approach
  - A subjective test – institute procedures/justify and record decisions
  - Emphasis on management of risk
  - Should apply across the business
  - Ensure process works/re-evaluate

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## 4. What to do (iii)

### Regulatory Impact:

- FSA in some turmoil but has been looking more closely at liquidity risk
- Also looking closely at whether financial and operational risks are adequately covered
- Broader business risks being addressed indirectly as part of concern regarding liquidity and may be more pronounced in future – due to weak response to Northern Rock crisis
- Focus on consumers and TCF remains high

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## 4. What to do (iv)

- Responsibilities/Ensure they are clear:
  - Finance to have responsibility for financial risks – other than credit risk
  - Credit risk to be allocated to independent (in-house) credit specialists
  - In-House legal to cover legal and documentation risks, add value in risk identification and assessment (see next slide)



## 4. What to do (v)

### In-house lawyers

- Legal risk is becoming recognised as a risk category following actions resulting:
  - Legal risk checklists are now being produced
  - What is an acceptable level of risk?
  - System of analysing risks – ratings
  - Periodic review of documentation
- But legal advisers also have to deal with aspects of risk identification, assessment and management in their day-to-day activities