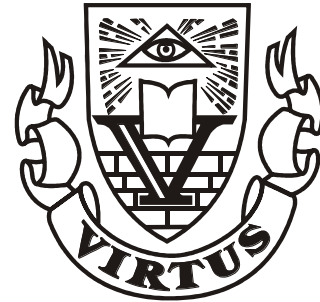


RISK GOVERNANCE & CONTROL: Financial markets and institutions

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DEVELOPING "BEST PRACTICES" FOR BANKERS' PAY IN LINE WITH BASEL III 7

Peiyi Yu, Jessica Hong Yang, Nada K. Kakabadse

This paper proposes hybrid capital securities as a significant part of senior bank executive incentive compensation in light of Basel III, a new global regulatory standard on bank capital adequacy and liquidity agreed by the members of the Basel Committee on Banking Supervision. The committee developed Basel III in a response to the deficiencies in financial regulation brought about by the global financial crisis. Basel III strengthens bank capital requirements and introduces new regulatory requirements on bank liquidity and bank leverage. The hybrid bank capital securities we propose for bank executives' compensation are preferred shares and subordinated debt that the June 2004 Basel II regulatory framework recognised as other admissible forms of capital.

GLOBAL RECESSION AND MICROFINANCE RISK GOVERNANCE IN DEVELOPING COUNTRIES 17

Roberto Moro Visconti

Global recession, started in 2008, is still proving an unresolved perfect storm and the financial crisis has affected also the real economy, creating widespread social unrest. Microfinance institutions (MFIs) in developing countries seem however less affected by the worldwide turmoil, due to their segmentation and resilience to external shocks. Recession has a big impact on governance mechanisms, altering the equilibriums among different stakeholders and increasing the risk of investment returns; any governance improvement is highly welcome and recommended. No governance, no money for growth or bare survival. In the confused phase we are living in, at the moment there are not evident winners, but the underbanked poorest, unless properly supported, once again risk being the ultimate losers.

ASSET CORRELATION, PORTFOLIO DIVERSIFICATION AND REGULATORY CAPITAL IN THE BASEL CAPITAL ACCORD 31

Sylvia Gottschalk

In this paper, we analyze the properties of the KMV model of credit portfolio loss. This theoretical model constitutes the cornerstone of Basel II's Internal Ratings Based (IRB) approach to regulatory capital. Our results show that this model tends to overestimate the probability of portfolio loss when the probability of default of a single firm and the firms' asset correlations are low. On the contrary,

probabilities of portfolio loss are underestimated when the probability of default of a single firm and asset correlations are high. Moreover, the relationship between asset correlation and probability of loan portfolio loss is only consistent at very high quantiles of the portfolio loss distribution. These are precisely those adopted by the Basel II Capital Accord for the calculations of capital adequacy provisions. So, although the counterintuitive properties of the KMV model do not extend to Basel II, they do restrict its generality as a model of credit portfolio loss.

THE ROLE OF THE RISK CONTROL FUNCTION UNDER THE BASEL II FRAMEWORK

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Thomas Dietz

The internal governance structure of a bank is crucial for surviving stress situations or for avoiding them at all. This has been proved once again during the financial crisis, where institutions with a bad internal governance structure were hit the hardest. A crucial part of the internal governance structure is an independent risk control function providing independent reporting to the management body and senior management. Basel II aims at strengthening risk management within the institutions in order to enhance financial stability. Has Basel II failed because it could not prevent the financial crisis starting in summer 2007? This popular argument cannot really be subscribed to. The following article takes a closer look at the provisions and – primarily driven by the financial crisis - at current suggestions for strengthening the rules further.

ON THE OPTIMAL DESIGN OF RISK RETENTION IN SECURITISATION

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Metin Kaptan

This paper examines the optimal design of retention in securitisation, in order to maximize welfare of screening per unit of retention, assuming that screening is costly and that the bank intends to securitise its loans. In contrast to the focus of previous literature on tranche retention, we deviate from the constitutional mechanisms of tranche retention to present a pareto-optimal method of tranche retention. Unlike the current ad-hoc-regulations, we derive the optimal design of retention from a utility maximization problem. We show that the level of retention per tranche should be dependent on the rate of credit default, i.e. the higher the rate of default, the higher the optimal rate of retention required to provide an incentive to screen carefully. From this approach, it follows that the rate of retention per tranche should be higher, the higher the position within the ranking order of subordination. Accordingly, the efficiency of tranche retention can be enhanced, reducing the level of retention required to maintain a given level of screening-effort. This retention design entails a recovery of the bank's equity capital, thereby increasing liquidity and lending capacities.

NORMS AND INTERNATIONAL STANDARDS RELATED TO REDUCE RISK MANAGEMENT: A LITERATURE REVIEW

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César Fuentes, Edmundo R. Lizarzururu, Edgar Vivanco

The current work aims to develop a revision of the literature within the main concepts in the international rules and standards related to risk management in companies. By this way, there will be an analysis of issues such as the COSO - ERM model, an introduction to the ISO 27000 and 31000 standards; and the Project Management according to PMI targeted at risk management.

SUBSCRIPTION DETAILS

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