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BRIEFINGS
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How the West Was Wrong:
Lessons for Egypt from the Financial Crisis
By Mohamed Elbanna

Although the cause of the current financial crisis within the United States and beyond can be attributed to a number of factors, the most significant of these is the mismanagement of risk. Risk management, in one form or another, has always been the cornerstone of American banking. However, the current crisis has revealed a number of factors within risk management that have led to the failures experienced across the Western financial frontier and beyond.

The Six Major Factors

The six main ways that risk was mismanaged by Western financial institutions, are:[1]

1. Reliance on historical data.
2. Focus on narrow measures.
3. Disregard of knowable and concealed risks.
4. Lack of communication.
5. Failure to manage in real time.
6. Poor capital reserve requirements.

1. Reliance on Historical Data

Historical data has been one of the backbones of Western risk management since its inception. Nevertheless, this was one of the main factors that lead to the recent mismanagement of risk. The simple explanation for this is: times change. Every situation is different and comes with its own set of variables. History can be used as a guide, but the varying factors that come with time make it too feeble to be used as a total support system for risk management.

2. Focus on Narrow Measures

Prior to the financial failure, many Western financial institutions used a system of monitoring risk, which focused on daily measures. However, this narrow focus led to severe problems when assets couldn't be sold quickly. This method didn't actually measure risk at all; it poorly predicted an institution's actual overall financial health. While many companies thought they were well off with only a few risks, they were actually in far worse trouble than their measurements showed.

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[1] *René M. Stulz, "Six Ways Companies Mismanage Risk," Harvard Business Review, March 2009.*

3. Disregard of Knowable and Concealed Risks
Risk management is dependent upon discerning which risks are the most volatile, and dealing with these accordingly. When risks are ignored, disastrous results follow. This scenario was played out with many Western financial institutions, which mismanaged risk by simply overlooking the risk itself.

4. Lack of Communication
Communication is key. As was the case with the West, no matter how advanced a company's risk management software or capabilities are, if this knowledge cannot be clearly translated to its Board of Directors and Chief Executive Officer (CEO), failure is the only possible result.

5. Failure to Manage in Real Time
Risks are in a state of constant, daily fluctuation. When institutions view risk management as a task rather than a process, they face severe repercussions. This is exactly what happened to a large number of Western banks who failed to consistently monitor their evolving risk profile. Sudden fluctuations in the market were ignored, neglected, or noticed too late, leading to severe repercussions.

6. Capital Reserve Requirements
One of the leading factors behind the mismanagement of risk experienced in the Western financial sector was the lack of adequate capital reserve funds. In many instances, increased risk led to increased profit. However, instead of saving this profit as capital, the money was distributed in the form of bonuses to top executives and managers. When these risks began to falter, there was no back up, leading to the turmoil currently being experienced by financial institutions across the globe.

Risk Management in Egypt

Within many Middle Eastern financial institutions, the implementation and focus on risk management is still in development. Nevertheless, the importance of risk management cannot be overlooked. After a 50 percent rise in net profit, Egypt's National Societe Generale Bank (NSGB), for example, stated that to continue on a path of productivity, they will continue to focus on risk management.[2] Likewise, The Central Bank of Kuwait recently introduced stress testing to enhance their risk management capabilities.[3] And, unlike the West, the Middle East is better positioned to successfully implement risk management procedures. The top three reasons for this are:

- Risk management is young.
- Adherence to Basel II.
- Islamic banking.

[2] *"Egypt NSGB bank Q1 net profit rises 50%," Egypt National Societe Generale Bank (NSGB), [http://news.egypt.com/en/200905136031/news/-business/egypt-nsgb-bank-q1-net-profit-rises-50.html], 14 May 2009.*

[3] *"Kuwait central bank enhances risk management of banking sector,"* ***Business Intelligence Middle East, [http:// http://www.bi-me.com/], 14 July 2009.****.*

Risk Management Is Young
Throughout the Middle East, risk management is still a fairly young science, only gaining wide acceptance within recent years. Although this poses a few problems, mainly, that risk management knowledge is still developing, it also allows for many advantages. Without a rigid foundation, risk management is better able to evolve with the times and address the current and future risks that challenge the industry.

Adherence to Basel II
Many U.S. institutions didn't adhere to the strong capital reserve standards implemented by Basel II to employ strict laws and regulations specifying how much capital should be held to protect institutions from risks. In the Middle East, on the other hand, Basel II is the prevailing standard, and because of this, banks are further protected from one of the most important factors that led to the current crisis.

Islamic Banking
Finally, the Middle East is populated with many Islamic banks, which allows for a clear advantage when it comes to risk management. While Western banks are mainly credit-based, Islamic banking is more reliant on an asset-based banking system. Because of this, Islamic banks do not have the same risks that conventional banks have, due to the fact that risk is largely a function of credit.

So What's the Risk?

Although many Middle Eastern countries stand in a better position to avoid risk mismanagement than the West, there is still a great deal to be learned from the mistakes of others. As risk management further develops within the Middle East, it will continue to be susceptible to all of the same issues and problems that have recently devastated the Western financial sector. To prevent this, Middle Eastern financial institutions must develop quality training programs throughout the organization to help manage risk. What Middle Eastern banks and financial institutions need to remember is that although learning sometimes involves making mistakes, it is always better to learn from the mistakes of others, than from your own.

Mohamed Elbanna is Chief Compliance Officer for Galaxia International Service – a Money Services Business serving the Middle East Region. Mohamed has more than twenty years of experience in the Financial Services Industry in compliance, accounting and operations management with his current focus being Compliance and Anti Money Laundering. He serves as a special advisor for Middle Eastern banking to The Edcomm Group Banker's Academy.