



The failure to have sufficiently adequate policy standards for "stress testing" the tolerance for risk significantly contributed to the market meltdown



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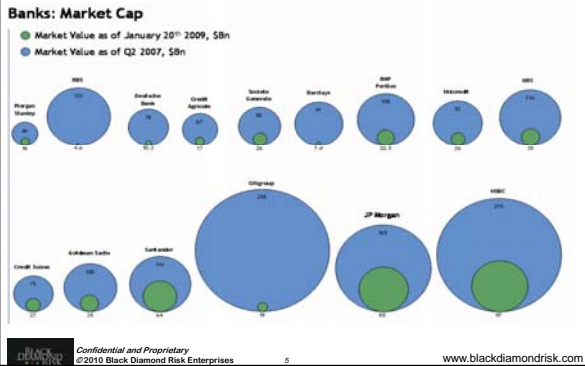
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The market meltdown has led to the need for a shared set of "Generally Accepted Risk Principles (analogous to GAAP)



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The failure to have sufficiently adequate "industry led" policy standards significantly contributed to a failure to control "systemic risk" (e.g. across the mortgage broker, bank, insurance, SIV and hedge fund market place)



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**Early example of Industry led policy standards**  
**The G30 Report –Recommendations on Derivatives Use**

- 24 recommendations (20 for users, 4 for regulators) – seen as best practice standards
- Recommendations 1 – 10 (remaining recommendations shown in Appendix)
  1. Derivative usage to be consistent with risk management policies
  2. Positions should be marked to market at least daily
  3. Mid-market valuations should be used
  4. Sources of revenue should be known and risk assessed
  5. Market risk should be calculated daily
  6. **Stress testing should be carried out**
  7. Cash and funding requirements should be determined
  8. There will be independent market risk management
  9. End-users (customers) should adopt the same risk practices
  10. Credit exposure should be measured

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**PRMIA Ten Principles for standards of Good Governance**

- 1 Key Competencies (e.g. **strong bios**)
- 2 Resources and Processes (e.g. **sufficient budget**)
- 3 Ongoing Education and Development
- 4 **Compensation** (e.g. **on par with revenue generators**)
- 5 Independence (e.g. from the revenue generators)
- 6 Risk Appetite (from top to bottom of the enterprise)
- 7 External Validation
- 8 Clear Accountability
- 9 Disclosure and Transparency (**transparency of the risk**)
- 10 Trust, honesty and fairness of key people.

See Appendix for PRMIA standards of best practice, conduct & ethics

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**Methodology Example: A key methodology challenge is to develop standards to compute meaningful risk adjusted measures of performance in both normal and stressed markets**

Need for a process to establish standards for computing Risk adjusted Profit and Economic Capital based on **Generally Accepted Risk Principles** (Analogous to GAAP)

The diagram illustrates a methodology for computing risk-adjusted performance. It starts with 'Objectives and Constraints' (including Revenues, ROE, and constraints like transaction type and risk exposure). This leads to 'Authorized limits' and 'Transactions (within the authorized limit)'. These are combined with 'Fixed and variable costs' to determine 'Market risk', 'Credit risk', and 'Operational risk'. These three risk categories are then used to calculate 'Risk Adjusted Profit' and 'Economic capital', which together form the 'RAROC' (Risk Adjusted Return on Capital).

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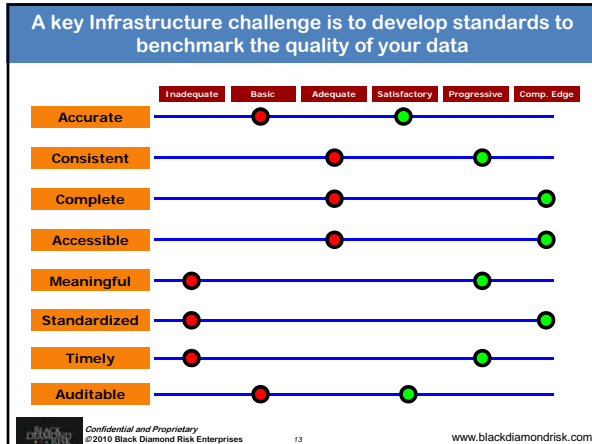
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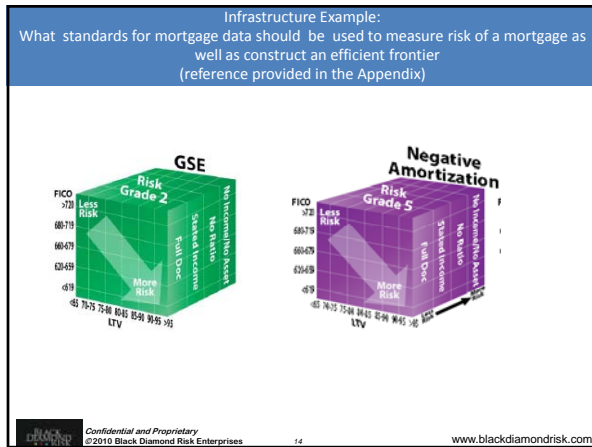
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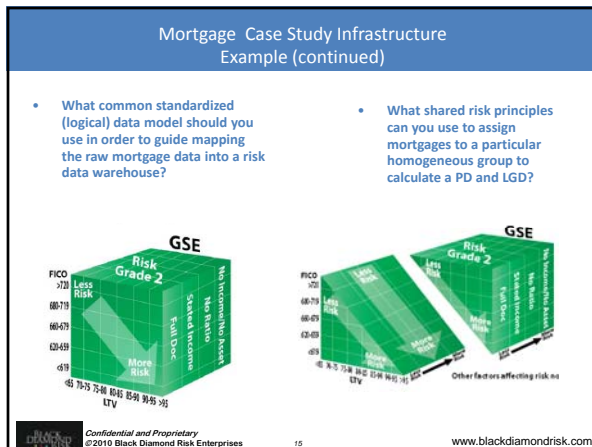
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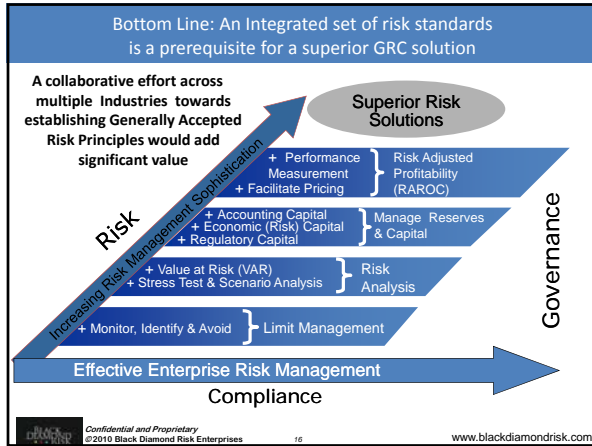
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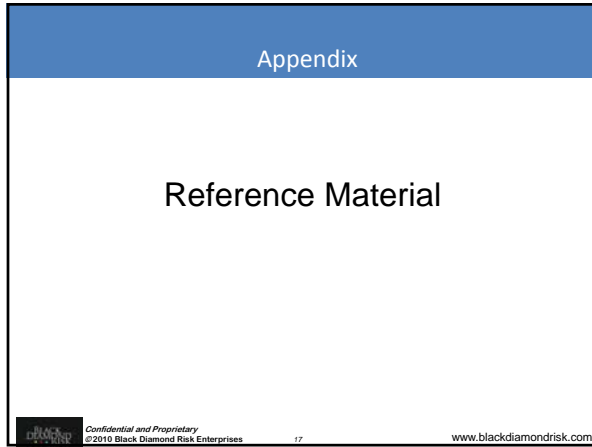
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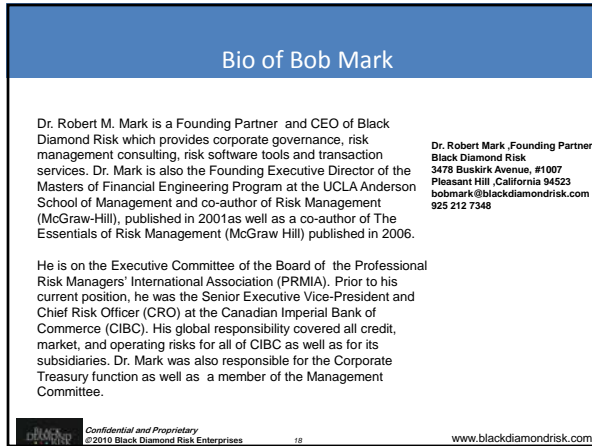
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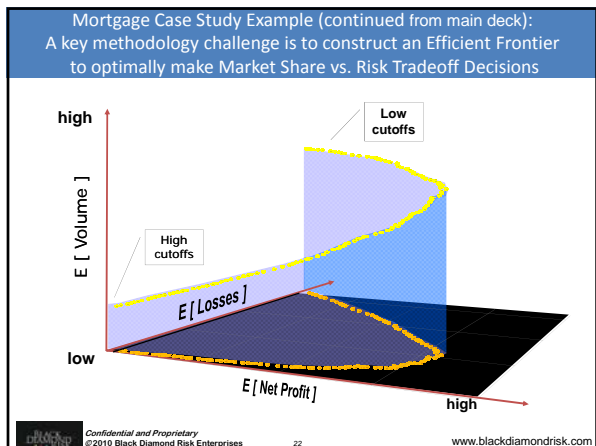
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