Federal Financial Analytics, Inc.

Financial System, Regulations Ill-Prepared for Geopolitical Risk Sparked by Ukraine Crisis

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CONTACT: Arezou Rafikian (202) 589-0880

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Despite the edifice of tough rules mandated since the 2008 crisis, global finance is singularly unprepared for geopolitical risk on the scale now posed by the crisis in the Ukraine, a paper released today by Federal Financial Analytics demonstrates. Partly due to the 2008 crisis, financial markets have changed in ways that can quickly turn local conflicts into cross-border systemic risk, with both current rules and most geopolitical-risk models sadly out of date, the paper concludes. For example, current risk models look principally at the credit risk to which banks are exposed even though liquidity risk resulting from fire-sales of sovereign bonds are a more likely spark to a 2014 geopolitical-risk market crisis. The rapid development of high-frequency trading can turn minor market disruptions into systemic shocks, while cyber-warfare poses risk only now being addressed in the global payment, settlement, and clearing systems. Little to none of this critical infrastructure is currently covered by effective stress tests or orderlyresolution requirements, making it a particularly weak link in the global geopolitical risk chain, the paper concludes.

"You can blame big banks for a lot, but not Russia's annexation of Crimea," said the firm's managing partner, Karen Shaw Petrou. "Post-crisis rules understandably deal with all the failings by big banks and their regulators that precipitated the crisis and made it as bad as it was. However, steps must be taken urgently now not only to ensure that financial institutions can absorb geopolitical risk, but also that governments ready robust shock absorbers."

In this paper, Federal Financial Analytics (FedFin) analyzes the sources of geopolitical risk and solutions to it, emphasizing the need for advance planning by both financial institutions and their regulators (who should work in close concert with national-security authorities to anticipate risk in this arena). As the Ukrainian crisis demonstrates, sanctions can come from events that can be anticipated only with astute geopolitical-risk monitoring and that can be absorbed only if cross-border institutions have effective systems in place ahead of time to ensure immediate compliance. Failures here not only threaten national security, but can also put a firm's charter at grave risk.

To the extent geopolitical risk is now addressed in the rulebook, it is covered only in bank standards aimed at "operational risk" – that is, the risk that systems falter. This operational-risk framework is largely premised on the belief that most of this risk comes from bad or negligent behavior by big banks, with the rules also discounting the value of risk mitigation like insurance or back-up systems. It is thus wholly ill-suited to the current state of heightened geopolitical risk.

Even more worrisome, non-bank financial institutions come under no operational-risk management standards despite the systemic risk some can quickly pose when global finance takes a direct hit.

FedFin's analysis lays out steps cross-border financial institutions – banks and non-banks – should quickly take to rebuild geopolitical-risk management and mitigation capability. The paper also urges regulators quickly to update the operational-risk rules where they apply to banks to ensure that they ready systemic institutions for geopolitical risk and, where the rules do not apply, develop effective buffers or impose comparable operational-risk standards to ensure robust geopolitical-risk capability.

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A Copy of this paper is attached and can also be found at

http://www.fedfin.com/images/stories/client_reports/Geopolitical%20Risk%20Analytics_FedFin_3%2011.pdf

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