Libyan Bank of Commerce Case Study – Analysis and Answers

Urgent Problems

1. The missed payment from Libyan Petrochemicals Ltd.

This problem demands immediate attention because it may suggest a bigger credit loss is developing. Second, it needs to be brought to CEO Habib to avoid a "surprise" for senior management. While it may help to see informally whether Libyan Petrochemicals has missed payments to other banks, often this information is difficult to obtain even confidentially, and second Mustafa will be avoiding dealing with the issue in the bank. It is not practical for Mustafa to work around his management and talk directly to CEO Habib without permission. However, Maurizio and Naser are obviously hesitant to bring bad news to the CEO. Therefore, one solution is for Mustafa to write a memo to Maurizio describing the problem and what he is doing at the moment (such as making sure the payment was not lost in the bank). Second, Mustafa should strongly recommend to Maurizio that he send a copy of this memo to CEO Habib. In this manner the CEO will be informed about the problem, without Maurizio having to be the only person to deliver to him "bad news". Also, if Mustafa writes the memo it will be in proper Arabic with full detail, something Maurizio may not be able to do alone.

2. Missed payments in the Operations Department

Clearly something went wrong with the systems project in the Operations Department. Even though Abdul is a good friend of Mustafa, it is still the responsibility of Mustafa to see that these problems are resolved. He should meet with Abdul and ask for progress regarding the systems project. He does not need to mention that he heard about Yasmin's complaints, but he can ask whether Abdul has thought about doing a manual check of names and account numbers as a way to sort out the problems. Ultimately, Risk Management has the responsibility of monitoring payments problems until the error rate gets back to a normal level.

Intermediate Problems

3. Credit and Operational Controls

The credit limit system needs reform. Mustafa should work up a plan with his manager Maurizio that would cover best practices for banks that are following Basel II. The limit system should have: a) separate limits for different types of credit risks, b) credit limits and exposures organized by maturity, c) separate controls (such as Key Risk Indicators) for operational risks like payments and settlements overages/delays, d) an independent report that monitors limit overages and payment problems, and follows-up on responses. Item d) should be a report prepared by Risk Management, not by the head of Corporate Lending using desk notes.

It seems very likely that the policies and procedures governing bank limits need to be rewritten. Mustafa should include this in his proposal. The proposal on limits and new policies/procedures should be presented by Maurizio to CEO Habib and other senior management for approval. There should be a clear understanding of the systems work required, the budget amounts needed, and the time necessary to complete this project, which presumably will be Mustafa's responsibility.

Preparing a valuation of potential loss for credit and operational risks is always a difficult task, but it appears that LBC has no approach at all. Maurizio and Mustafa can develop some sophisticated valuation models over time, but for the immediate future, it seems the best approach is to use a percentage of loan amount, or similar calculations, that have been developed by the regulators for Basel I and Basel II. These percentages have the advantage of being understood by the central bank, and being accepted as an industry practice. Similarly, for operational risk there are basic formulas in Basel II that help LBC calculate potential loss from the operational risk. Eventually, Risk Management will have to work with the bank's Chief Financial Officer to develop a capital charge system, whereby the businesses are charged a hypothetical capital amount for calculations such as loss given default.

4. Missing Customer Exposures

The missing credit and operational exposures of companies like Libyan Petrochemicals must be added to the new reports being prepared. The practice whereby the CEO of LBC is the only person who monitors these exposures must stop. This practice violates many sound policies of risk management, including the need for transparency of risk, the need for more than one person to see and understand these risks, and the need for an independent assessment of risks. It is Maurizio's responsibility to convince CEO Habib of the need for these changes. Maurizio's best argument to use is the best practices argument, and his best allies in making this argument – if he needs help – are other executives in the bank such as Naser, or outside regulators at the central bank. Maurizio should point out that inevitably the regulators will require that all significant exposures be monitored on risk reporting systems, and that LBC is better doing this itself rather than waiting to be ordered to do it.

5. Anti-Money Laundering Report

The details of this reporting requirement will not be known until the meeting next week with the regulators. However, Mustafa needs to keep in his mind what these requirements are likely to be, because his limit reporting project could probably be designed to generate the cash payment information necessary to comply with the Anti-Money Laundering Report. Similarly, LBC needs to develop a policy on this matter as well.

6. Market Risk

It is not true that LBC has no market risk. As long as a bank borrows short and lends long, it has substantial balance sheet exposure to interest rate changes. Also, the mission of LBC, now that it has foreign bank ownership, is to expand into trading. Mustafa should play close attention to what the regulators say about market risk reporting, because there is a major project that is going to occur, possibly in a few months time. This project will allow Mustafa to work more closely with risk managers at the Italian bank, and learn new things from them.

Also, LBC has very substantial, indirect market risk, in the form of exposure to oil price changes. Obviously at least one customer, Libyan Petrochemicals, may have problems meeting its obligations because of the dramatic recent drop in the price of crude oil. Since LBC is a major hydrocarbon bank, it is important that senior management keep close watch on the energy markets. A proper analysis of the credit portfolio would always include an estimate of losses given major changes in energy prices.

Long Term and Management Challenges

7. Operations Department

Was Abdul the right person to head the Operations Department? There are some yellow flags up regarding his performance. Mustafa should have a confidential discussion with his manager, Maurizio, about his concerns. If these problems persist, it is Maurizio's responsibility to inform CEO Habib of the personnel risk in the Operations Department management.

8. Risk Monitoring by Naser

Naser said he was monitoring credit limit overages using notes he kept on his desk. He also said he would bring serious problems to the attention of CEO Habib. However, he did not seem familiar with the late payment by Libyan Petrochemicals, which indicates his system of monitoring overages does not work very well. Second, when Mustafa needed him to bring the late payment to the attention of CEO Habib, Naser refused, so here again he is not effective at dealing with risk problems.

This shows that relying on one person to do significant risk management – even if that person is a high executive – often has problems. That person may be busy, or not in the bank, or simply not willing to deal with a problem. It is much better to have policies, procedures, and a risk management process where the responsibilities are clear, and there are several people involved in the process. This is even more important when the "risk manager" is the CEO, because the CEO is at the top of the chain of command. He is difficult to reach and difficult to criticize if he does not do his risk management job well. The CEO and other executives should be concentrating on fundamental strategic and reputation risks, and on the risk management systems and processes for credit, market, operational and other risks, to ensure that all major risks are understood, measured properly, and managed well.

9. Independence of Risk Management

The conversation Mustafa had with Naser suggests that this executive does not view the Risk Management Department as truly independent. First, he believes he can order Mustafa to do something. Second, he believes Mustafa should fix problems before the Corporate Lending Department loses money. Third, he believes Mustafa's promotion and bonus are dependent on the success of the line of business, implying that Naser himself can influence Mustafa's rewards. If LBC is running a true, independent risk management function, all of Naser's assumptions are wrong. Mustafa therefore needs to have a conversation with Maurizio about these concerns. It is essential that Maurizio work with Naser, CEO Habib, and other executives to clarify exactly the responsibilities, authorities, and independence of the Risk Management Department. If Mustafa continues to get the impression from executives in the bank that Risk Management is not independent, he may have to consider changing his career and leaving the department, because sooner or later problems which come up will be blamed on Risk Management whether they are responsible or not.

10. Maurizio's Skills

It is always a challenge working for a manager who is not fully familiar with the bank's culture, or who has trouble communicating. Maurizio in a sense has two bosses, in that he reports to CEO Habib, but probably has to keep the Italian bank owner aware of the safety and soundness of LBC. Mustafa needs to be patient and hope that Maurizio over time will become more active and comfortable in his job. Mustafa should also learn as much as he can about risk management from Maurizio, should support him in his work, and should be very careful not to undermine his manager. Maurizio not only can teach Mustafa much, and help the bank in the process, he probably will only be staying a few years in this job. Mustafa is an excellent candidate to replace him if he learns much more, and is supported by Maurizio as his replacement.