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Attention: Basel Committee Secretariat

Ref: Comments on the New Basel Capital Accord

RealBiz International AB is a Swedish management consulting company. This company has developed a computer supported system for assessing businesses, soon available on the Internet as a standard tool. At this time, the system has been used with excellent results for more than 1.000 businesses of all sizes, industries and in many countries.

We have read with great interest the report on risk assessment and capital requirements of the Swedish Finance Inspection Authority (Finansinspektionen: Riskmätning och kapitalkrav; Rapport den 14 februari 2001) and your press release of January 16, 2001. After having been in contact with the Swedish Finansinspektionen Mr Johan Grönquist on the subject, there are a few points that we would like to comment upon,.

Our comments are based on three fundamental statements that could have profound influence on the New Basel Capital Accord. They concern:

- 1. The understanding of the concept Value.
- 2. The understanding of the possibilities to foresee the future.
- 3. The understanding of what could threaten a healthy development of a borrower.

1. **The concept "Value"** is a tricky subject. The word can have several meanings, which are often used in accounting without due consideration of the implications. At least two meanings need to be distinguished, "amount", as a number that has been recorded or registered, and "usefulness", the value an item may have to a user. It is not clear to us which of the two meanings are implicitly used in the New Basel Capital Accord. If it is value = usefulness, as it seems to be at times, it can not be treated as a property of an asset. "Value" in this sense is a subjective feeling of the beholder, e.g. the potential buyer of shares in the stock market or a company in a merger/acquisition situation. A value in the meaning "Usefulness" is therefore not possible to calculate or even express in a number. Consequently there is by definition no method to calculate a value of an asset = usefulness.

The values used on a balance sheet are values in the meaning "Amount" and are not correlated to value in the meaning "Usefulness" to the owner of the assets. Consequently such factors as Total assets, Equity and Goodwill are not related to any value (usefulness) of a company and cannot be used as measurements of a company's well-being.

This is one of the basic reasons why traditional accounting becomes less and less relevant when assessing companies. Balance sheets and P&L statements are therefore not useful bases for decisions on financing.

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2. In the New Basel Capital Accord one has not taken into account the fact that **the future is genuinely unpredictable**. Through the history of mankind, this has always been true. In today´s situation of fast technological, political and fashion changes, it is more true than ever. Peter Drucker calls it “The Age of Discontinuity”, Percy Barnevik “a time of uncertainty”. Consequently historical data, trend extrapolations, cash flow forecasting etc. are of no use when assessing the future performance of a company since nobody has the full control of its environment. We feel that the Committee has not given enough attention to this reality, when the Accord suggests that five or in some cases seven years of historical data on borrower must be available to use the system of Internal Rating. Historical data have very limited significance, if any at all, in assessing a company´s credit worthiness.

As is stated in the section regarding Capital Requirements the capital is required to protect the credit institute from unexpected credit losses and not from expected credit losses. Credit institutes must therefore assess the future performance of individual borrowers, mostly companies. It is not possible to do so based on the historical performance. The physical limits tell us that the closest we can get to an assessment of the future performance of a company is to assess <u>today’s conditions for the future development</u>. These conditions, however, are not based on financial considerations. They depend totally on a fundamental measurement of the company’s freedom to act in relation to its environment. We enclose a forthcoming article in “Internal Auditor, Global perspectives on Risk, Control, and Governance published by the Institute of Internal Auditors, IIA, written by a member of IIA, Mr Sten Bjelke; dealing on the subject. Appendix 1.

Since the future is genuinely unpredictable there is no way, other than pure guesses, to establish the probability of a given event with low frequency and in an ever changing environment. This fact, in our opinion, should be reflected in the New Accord when assessing operational risks. Forecasting and trend extrapolation should be ruled out in serious business assessments.

The proposal has also another problem in this context. It is based on the “most important risk events”. As shown in Appendix 1, this is not a possible approach to the problem, since the number of such events is infinite by definition.

The solution to the problem suggested in Appendix 1 is based on the statement that all companies, like other living organisms, live of their environment.. It is therefore the environment that puts up the threats and limits to the development of a company. A given operation has a limited number of interested parties and factors in its environment that can influence its operations. These parties and factors and the impact they have on the company can be defined and measured.

Any assessment of operational risks of a financial institute or assessment of the creditworthiness of a borrower should therefore be based on a fundamental measurement of these dependencies, summed up as its level of “freedom to act”. This is shown by its so called Business Position that identifies and assesses the possible “triggers” of a harmful development.

The remarks above are written in a very compressed way. RealBiz International AB is however prepared to further develop our comments in any way the Committee may want.

Yours sincerely

Per Erik Kihlstedt

President RealBiz International AB   Copy: Mr Johan Grönquist, Finansinspektionen

Appendix 1

Risk Assessment - Mission Impossible?

Internal auditors are today more interested in risk and risk assessment than ever before. The most important reason is probably the changing paradigm, described by David McNamee and Georges Selim in the report Risk Management: Changing the Internal Auditor's Paradigm, The IIA Research Foundation 1998. That change is now mirrored by the definition of internal auditing.

The term "risk" is defined in the Glossary section of the Standards for the Professional Practice of Internal Auditing as "The uncertainty of an event occurring that could have an impact on the achievement of objectives. Risk is measured in terms of consequences and likelihood".

From Control Risk to Business Risk.

Obviously internal auditors risk focus is changing from control and audit risk to business risk. Business risk is not necessarily a consequence of bad control. It is rather a necessary and desirable everyday occurrence, since one risks something in order to achieve something more. Thus, control reviews can no longer be used as a basis for the audit planning.

☞ **Auditors' traditional risk assessment methods are no longer fit for use.**

Though business risk assessment is something new for many internal auditors it is not a new subject for management. Since many years business risk assessment is a regularly repeated activity carried through by management as an integrated part of the business planning process. Sometimes these assessments are carried out in accordance with a systematic method, sometimes not. No matter how they are done, normally management is in a much better position to identify and validate business risks than the internal auditors. Why then don't internal auditors use the risk assessments behind the business plans as a basis for the audit plan?

One reason could be that risk assessments behind the business plans are seldom systematic, clearly expressed and consolidated. As there has been little or no demand for consolidated risk assessments they are usually carried out in such a way that the result can't easily be accessed.

There are risk assessment methods developed for audit purposes that compensate for this problem. In principle these methods revalidate the risks identified by responsible business unit officers on a consolidated basis. Arthur Andersen’s accountant firm has developed one good example of such a method. These methods are very cost effective and often very appreciated by management. Unfortunately they don't compensate for uncertainties due to technical shortcomings, as we shall se below.

☞ **Even the best risk assessment method will add no lasting value to an organisation if it is exposed to technical shortcomings.**

How to identify risk.

The most common assessment technique used to identify risks and opportunities focuses on events. Often events are embedded in activities or scenarios or other expressions for chains of several events. This approach is supported by the current definition of risk in the Glossary section of The IIA Standards.

By experience we know however that no one can predict what will happen in the future. In other words, there are an unlimited number of possible events.

☞ **The present definition of risk: " The uncertainty of an event…." leads us into a dead end street, since it is impossible to foresee all possible events!**

When assessing risk the most common technique used to handle this situation is to focus on *probable* event instead of *possible* events. Low historical or expected frequency does not guarantee that something of importance will not occur within the time of interest. Unfortunately this exclusion of improbable but possible serious events dramatically increases the uncertainty of the assessment and limits its value. (Luckily this logic is not always used. Airlines still check your safety belt before landing although rough landings are very rare.)

Unexpected events have more important impact on organisations than expected events. Eleven Nobel Prize Winners on Swedish Television December 16, 2000 confirmed this conclusion. Unexpected events are by definition never frequent. Using probability means that the importance of events with low expected frequency but high impact is systematically downsized.

☞ **Using probability to select events of future interest is counterproductive to the purpose of the assessment.**

As said above, there are an unlimited number of possible events. Since it is impossible to identify an unlimited number of events, it is also impossible to assure that all events of interest have been identified.

☞ **The unlimited number of possible events makes it impossible to assure that all events of importance have been identified.**

How to validate risk.

Also validating techniques might bring uncertainty to the risk assessments. The most common technique for validating risk is based on Pascal's Probability Formula: Risk = Estimated Impact multiplied by Estimated Probability during the timeframe of interest.

This formula was developed 1654 to calculate the expectations in a game of chance. It is *only* valid when:

1. Skills make no difference to the outcome.
2. Probability is calculated on a big number of observations.
3. The environment is under good (full) control.

If one or more of these conditions are not fulfilled, the uncertainty to the result of the calculation will be material. Usually none of these conditions are fulfilled when assessing business risk. Thus, *business risk validation should not be based on Pascal's formula.*

☞ **It is not the risk but the impact that hurts!**

Risk Assessment- Mission Impossible?

The *identification* problems highlighted above are mainly technique related and caused by the focus on a parameter (event) with an unlimited number of possible outcomes. To avoid those problems a technique must be used that focus on a parameter with a limited number of possible outcomes.

One method, developed in Sweden and used by organisations and auditors in Europe since 1984, is based on such a technique. It is called The RealBiz® Method. This method is focusing on "possible triggers". A trigger is someone or something in the external <u>and</u> internal environment with the power to trigger an event of importance to the organisation, regardless what. There are a limited number of possible triggers. Thus, all possible triggers can be identified and their possible impact validated.

☞ **With a technique that focuses on a parameter with a limited number of outcomes the assessment will be exposed to considerably less uncertainty. This also makes it possible to assure that all possibilities of importance have been identified.**

Also the uncertainty to risk *validation* can be reduced. With a technique that focuses on a parameter with a limited number of possible outcomes all possible impacts can be validated. Thus, possible outcomes can be used for prioritisation purpose. In that process the probability is not an important issue in most cases.

When using The RealBiz® Method probability is usually not important due to the fact that all triggers with power to cause an unbearable damage to the organisation will be identified. When the consequences are unacceptable the probability is only of academic interest.

☞ **Organisations don’t try to avoid risk. It is the possible impact that is important.**

How about the future?

During the last few years, investors’ tolerance to governance and management mistakes has continuously decreased. This trend is likely to continue. The risk assessments behind the business plan are corner stones to an organisation’s survival. Assurance of these assessments is therefore of vital importance to the organisations. Thus, internal auditors must be prepared to meet future demand for assurance of the business planning process including risk assessments. Such a demand we can't meet with the risk assessment technique commonly used today.

☞ **Internal auditors must be prepared to meet future demand for assurance of the risk assessments behind the business plans.**

Today, only one risk assessment technique is known that can be assured. This does not exclude the possibility that there might be other techniques that also meet this requirement. Research is needed. Is this may be something for The IIA Research Foundation?

The only thing we know for sure about the future is that it is unpredictable! Most likely the future of the internal auditing profession is very much depending on internal auditors possibilities to "add value" to our organisations. By developing our own risk assessment skills we will add value. Introducing more reliable risk assessment techniques to the business planning process will add much more value. A combination of booth these strategies will probably add even more value to our organisations risk assessment, control, and governance processes. What are we waiting for?

When preparing this article I have had a lot of help from the book "Against the Gods, The remarkable story of risk" written by Peter L. Bernstein. This book is today available at the IIA Bookstore. If you haven't already read it, do so! I fully agree with John Kenneth Galbraith, Professor of Economics Emeritus, Harvard University: "no one should miss it".

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Bjelke has been a member of The IIA since 1983. Among positions held are President of The IIA Sweden, Director on the Executive Committee and Management Board of The European Confederation of Institutes of Internal Auditing ECIIA, District Representative of The IIA European North Region, District and Regional Director on The IIA Board of Directors.