July 2013

Global Regulatory Network Executive Briefing

Global Regulatory Network

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Getting risk governance right

To succeed, a bank must take risk and receive adequate compensation for taking those risks. Risk governance is therefore central to the business of banking. As a consequence, regulators and investors are paying ever more attention to whether banks are getting risk governance right.

To assure these stakeholders that banks are in fact doing so, boards should focus on three broad questions:

1. Does the bank have the correct overall risk target?
2. Is the bank's business model aligned to its risk target?
3. Is the bank controlling risk correctly?

Good risk governance would enable the bank to answer "yes" to each of these questions.

Does the bank have the correct overall risk target?

The regulatory reform agenda has two major objectives: (i) to reduce the risk that banks will fail, and (ii) to make banks "safe to fail" so that they will be resolvable at no cost to the taxpayer and without significant disruption to the financial markets or to the economy at large.

Together, these regulatory initiatives will have a significant impact on banks. In finance terms, supervisors are seeking to eliminate banks' ability to adopt a high-risk strategy. First, supervisors are seeking to eliminate the ratings pickup that banks derive from the market's perception of implicit government support so that a bank's stand-alone rating and its overall rating do not differ. Second, supervisors are aiming to ensure that banks maintain a stand-alone rating that is comfortably investment grade at all times (even at the trough of the cycle) so that the bank will remain a considerable distance from resolution. The principal means to this end is higher capital and liquidity requirements.

To succeed in this new regulatory environment, banks must recalibrate their targets for risk and return. Prior to the crisis, many banks were too ambitious. They targeted return on equity (RoE) at 20% or more while stating that they would simultaneously maintain a credit rating of AA or better. But this combination of high RoE and low risk proved unsustainable. Banks will have to bring down their RoE targets to conform to the lower risk (and higher ratings) that regulators require.

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However, this new lower-risk and lower-return environment need not reduce the return to shareholders. Return to equity investors depends primarily on whether the bank earns a return in excess of its cost of equity, not on the target rate of RoE. As the risk to equity declines, so should the required rate of return on that equity. Low-risk and low-target-return equities can provide shareholders with total investor income from price appreciation and dividends that is as large as or larger than investor income generated by high-risk and high-target-return equities. However, a smooth transition to a strategy of lower risk-return can be challenging to achieve in practice, especially given continued market concerns about bank transparency, other agency issues, and the continuation of assumptions of implicit support (e.g. the ratings agencies continue to provide an uplift for implicit government support).

Keeping risk appetite within risk capacity is a precondition for success in the new environment. Risk capacity sets out how much risk the bank could take— roughly defined, this is the amount of money (in absolute terms) that the bank could afford to lose without reaching the point of non-viability. Risk appetite indicates how much of that capacity the bank wishes to utilize. Boards need to ensure that the bank's risk appetite is in line with the bank's risk capacity while recognizing that the bank has to be able to take a minimum level of risk, if it is to compete successfully in various lines of business.

In the long run, the bank's risk appetite cannot exceed its risk capacity. Either the bank has to raise its risk capacity or cut its risk appetite. Conversely, as risk capacity contracts, so should risk appetite, unless the bank can take countervailing measures quickly to restore capacity.

The prudent bank will therefore leave a cushion between risk capacity and risk appetite when setting its risk target. It will wish to hold some risk capacity in reserve, particularly as it is difficult to forecast how well funding will hold up, once the bank suffers a loss to capital. This reserve should be higher, the fewer or weaker the bank's recovery options are.

Setting a risk appetite and estimating risk capacity is not an exact science, but banks are making progress in establishing common measures and in designing tools to allocate risk appetite across the bank's lines of business.

Is the bank's business model aligned to its risk target?

The bank's business model has to spell out how the bank earns its money. At a minimum, the board will wish to periodically conduct what might be called a "business-model checkup." This would include a review of whether:

- The bank is overlooking one or more risks.
- The bank is mis-pricing one or more risks.
- The bank is spending too much to acquire or administer the risks that it does take.
- The bank has sufficient risk capacity to support its strategy.
- The bank allocates and controls risk appetite appropriately.

The business model must include all the risks that the bank takes. Had such an analysis been conducted prior to the crisis, banks might have seen that they were overlooking or underestimating liquidity risk, as well as conduct and operational risks.

The business model should ensure that the bank prices risk correctly. It should induce the bank's line businesses to demand externally a full price from the customer for the risks that the bank assumes and to pay a full price internally for the capital and liquidity that the line business requires. Undercharging customers for the risk of credit is particularly dangerous. Banks that follow such a policy will gain a disproportionate share of such credit and fail to earn enough income over time to provision adequately for the impairments that will arise.

The business model also has to ensure that the bank operates efficiently. Just as retailers keep a keen eye on their turnover-to-inventory ratio, so should banks review exactly which assets they need to hold for how long in order to generate revenue and profit. What distinguishes banks is their ability to respond quickly to customers' demands for new credit. Once a loan has been made, or a bond underwritten, banks are not necessarily the most efficient holders of assets. Investment funds exempt from corporate tax may be much better placed to hold assets.

This suggests that banks may wish to revive the "originate to distribute" strategy. To do so banks will have to build relationships with investors, to simplify the structures of asset-backed securities sold to investors and to improve disclosure on asset performance at origination and during the life of the security. It will also require banks to ensure that the loans distributed to investors conform to the bank's underwriting standards.

Banks will also need to further refine their compensation models. Regulation has done much to ensure that compensation is consistent with effective risk management. But more may need to be done. In particular, banks may wish to give consideration to transforming some portion of bonus to a share of any profit above the minimum required to cover the bank's cost-of-equity capital. Such a method would shift bonus "below the line" so that bonus would accrue only after the shareholders have earned a minimum rate of return.

Finally, the business-model check-up also needs to include a review of risk capacity and risk appetite. Is this large enough to allow the bank to compete? The bank should enter a business only if it has sufficient risk appetite (and risk capacity necessary to support that appetite) over a full credit or business cycle. For example, if a bank is to compete in offering credit cards to consumers, it has to be ready to offer customers limits that are in line with the spending habits and income of its target customer base.

Boards should also ask whether the bank can continue to control its risk appetite if others in the industry lose their risk discipline. At what point does pricing become so unsatisfactory that the bank will stop writing new business, and does the bank's business model give it the option to take a temporary pause until market pricing again reflects the risk to the bank? If not, is this a business that the bank can afford to be in?

Is the bank controlling risk correctly?

Finally, boards will want to know that the bank is controlling risk correctly. In effect, boards must ask how well the bank's "three lines of defense" are working.

The first line of defense is line management. How does it regard risk? Does the front office view risk as the core of what a bank has to manage and therefore actively participates in the effort to limit risk in relation to return, instead of just deferring to the risk management function?

The second line of defense is risk management and compliance. Is the former setting and controlling limits in line with the bank's overall targets for risk and return so that the bank remains within its risk appetite and does not exhaust its risk capacity? Does risk management have a role to play in key decisions of business strategy, or does it just get involved after the fact? With respect to compliance, is the bank adhering to all the relevant rules and regulations in each of the jurisdictions in which the bank operates? If a breach does occur, is it promptly remedied and does the bank draw the appropriate lessons? Finally, is compliance identifying issues that could become concerns in the future and taking steps to mitigate those risks?

The third line of defense is internal audit (IA). Is IA covering all the major risks the bank takes? Is IA testing the quality of the risk governance process and reporting findings to the board? Is IA discovering the right issues? Is management recommending the right remedies and implementing them promptly?

Bringing these elements together would create a strong risk culture at the bank and help lay the foundations for its lasting success.

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Global Regulatory Network

EY's Global Regulatory Network is an integral part of our Financial Services Office and enables EY to offer banks deep experience, leadership and insights on financial regulation.

Our global regulatory services are led by an executive team of former senior regulators, including former Basel Committee Secretary General Stefan Walter. This team, supported by more than 100 other former regulators, drives EY's strategic outlook on global regulatory themes impacting global banks, including capital, liquidity, resolution and recovery planning, risk governance and other emerging topics in banking regulation.

Stefan Walter was secretary general of the Basel Committee on Banking Supervision from 2006 to 2011. During this time, he was also a member of the Financial Stability Board. He has more than 20 years of international bank supervisory experience, including 15 years at the Federal Reserve Bank of New York.

Dr Tom Huertas is a former member of the FSA's Executive Committee. He also served as alternate chair of the European Banking Authority, as a member of the Basel Committee on Banking Supervision and as a member of the Resolution Steering Committee at the Financial Stability Board.

Patricia Jackson is the former head of the Bank of England Regulatory Policy. She was the head of the Financial Industry and Regulation Division from 1995 to 2003 and was a member of the Basel Committee from 1995 to 2003. She chaired the global Quantitative Impact Studies to test the effect of Basel II and chaired the Calibration subgroup.

Don Vangel, Regulatory Advisor to the Office of the Chairman, joined EY after a 17-year career at the Federal Reserve Bank of New York where he ultimately served as a Senior Vice President for Bank Supervision.

Urs Bischof is the former head of Risk Management of the Extended Executive Board of Switzerland's FINMA. His responsibilities included risk management supervision and oversight and prudential regulations, along with leadership roles with respect to Basel III, SIFI regulation, payments and clearing.

Marie-Helene Fortesa has extensive regulatory experience. Her posts have included leadership roles at the Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority), the Association Française des Banques (French Banking Association) and INSEE (French National Institute for Statistics and Economic Studies), as well as senior roles at a leading investment bank.

John Liver's experience includes a number of regulatory roles with leading investment banks as well as the UK FSA and its predecessors. His roles include head of thematic supervision in the Investment Firms Division, head of Personal Investment Authority Supervision, overseeing the sales regulation of the life and pensions industry, and management roles in Investment Management Regulatory Organization's Enforcement and Supervision Departments.

Phil Rodd, Keith Pogson and **David Scott** have extensive experience working with regulators across the Asia-Pacific region. **Hidekatsu Koishihara** is a former chief inspector and Inspection administrator for the Japan Financial Services Agency. He also worked at the Ministry of Finance of Japan (MOF), Japan's former financial regulator, serving as the financial inspector at the Bank Bureau of MOF and Financial Inspection Division, and Minister's Secretariat of MOF.

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EYG no. EK0157

CSG/GSC2013/1107718

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