Risk Management in Banking in the next decade

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Barings, Lehman, Northern Rock and Washington Mutual; what's the common thread underpinning these names? All have ceased to be part of today's financial landscape. Risks, albeit of different genres, hit these banks hard. Operational risk brought Barings down. Credit and Market related risks liquidated Lehman. Liquidity challenges rocked Northern Rock. And Washington Mutual fell flat when home prices collapsed; subprime mortgages turned out to be too fragile.

Taking Deposits to Lend Inherently Risky

The business of banking is inherently risky. In a classical sense, banks' basic business is to take deposits to lend. Depositors stay entitled to their money regardless of whether the money lent out comes back to the bank or not. Repayments, let alone interest on the monies lent, almost always remain somewhat uncertain. Businesses may and do fail. Individuals lose their jobs and earning streams. Industries get disrupted. Environmental or even political issues force closure of functional units. Economies experience downturns, sinking many boats. As prices drop, valuations tumble. Credit mitigation measures turn ineffective. No surprises why banking remains risky not only under stressed economic conditions, but even in the best of times.

The odds stack up high when banks fund ventures chasing a bandwagon idea or finance business models with fault lines that are not well understood. PPAs in the power sector are a case in point.

Choices made by Counterparties too impact risk

Banks usually carry out comprehensive pre-lending due diligence. Likewise, entrepreneurs too vet their business models before committing funds. And yet, on the way, ambitious growth, forays into new areas and other bets at times lead the otherwise thriving enterprises astray.

An occasional Enron or a Satyam nearer home also underline the risk that credit underwriters may unknowingly assume, when they lend to apparently successful, growth oriented companies that decide to unhinge themselves off the usual conduct standards.

Operational Risk Flare-ups

We are all familiar with frauds, near-misses and other operational hazards that banks face. External fraudsters are always a threat. A few black sheep here and there within the system are also a given. A certain amount of such risk is therefore inevitable. But, at times, a single soul could just bet the house; lock, stock and barrel. Remember Nick Leeson at Barings, Jerome Kerviel at Societe Generale, Kweku Adoboli at UBS and Bruno Iksil at JP Morgan – all marquee names that, one thought, were well equipped to handle the operational risks, but ended up taking huge hits.

RCSA & Best Practices

Risk literature teaches us to carry out RCSA (Risk & Control Self Assessment) exercises to spot cracks in controls to prevent mishaps. We are also encouraged to learn and implement best practices from the industry.

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And in any case, it's better to learn from others' mis-steps. Let's now take a look at the timelines of these major risk incidents and figure out if risk management practices changed for the better. Barings debacle happened in 1995. JP Morgan (JPM) got hit by what's popularly known as London Whale in 2012. Nearly two decades apart, the banking industry majors' capacity to handle risk perhaps remained static as incidents continued to recur and losses continued to surge. A loss of USD 1.3 billion reportedly sunk Barings. London Whale incident is said to have dented JPM to the extent of USD 6.2 billion. Reputation risk consequences were of course an additional downside.

GFC showcases what Risk build-up can lead to

Leaving aside the various incidents that have periodically popped up from nowhere, it would probably be in order to say that the 2008 Global Financial Crisis (GFC) surfaced all sorts of risk and unravelled a stark reality. Risk Management proved to be totally inadequate. In fact, one could argue that in 2008, Risk function either played along or failed big time in influencing business verticals to follow the right path, despite all the complex models and contribution of smart theorists. Tanking economies made it real scary.

Wave of Regulatory Reforms

GFC triggered a wave of regulatory reforms and risk acquired an altogether new dimension. Perhaps, realising that banks, in their pursuit of revenues and ROI, may not listen to their own Risk function, regulators started mandating independence and access to Boards for Risk. Dual hatting got thrown out of the window. Risk-based supervision became the norm. Role demarcations acquired clarity. Three lines of defence approach gradually took centre stage. Business or Line I not only turned more compliant (did hefty penalties help?), but also started listening better to Risk function (Line II). Internal Audit, called Line III, turned rigorous, at times hawkish in testing controls and flagging deviations. The era of lofty policies and lax practices probably ended for good.

Basel bolsters Capital Framework

In tandem, the Basel Committee on Banking Supervision (BCBS), backed by G-20 decision-makers, substantially enhanced the Capital Framework. A variety of approaches and models got developed to determine the capital required by banks vis-à-vis credit, market, operational and other risks. Internal Capital Adequacy Assessment Process or ICAAP in short became the fulcrum around which a bank's business had to be run. Pillar 2 scrutiny acquired unprecedented heft. Pillar 3 disclosures gained currency amongst investors and analysts.

Liquidity steps up the risk hierarchy

Alongside capital, liquidity emerged as a major issue. Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) got included in the risk tracking menu. Internal Liquidity Adequacy Assessment Process or ILAAP kicked in to account for liquidity risk.

What if Risk management fails to protect the bank?

Risk function is expected to provide the alerts and pointers when thresholds are breached and risk levels get elevated. The idea is timely course correction. However, a bank could still fail for want of responsive action or a variety of other reasons, necessitating resolutions. Concern for orderly resolution of banks in case of failures generated concept of living wills. Option of bail-ins as against bail-out by taxpayers' money also got considered and practised at least in one case in Cyprus.

Bouncing back

Post-GFC, two narratives are clearly discernible. The American Banks which recognised losses quickly and benefitted from TARP have bounced back faster and are firmly back in business. Banks in some other jurisdictions have not been as lucky, maybe partly due to differences in the underlying economic conditions. The other storyline relates to the complex web of regulations and requirements that has developed

for adherence by banks. Complexity is writ large all across. CET1, AT1, MTC, CCB, CCCB, BIA, TSA, AMA, IRB-F and many other acronyms rule the world of banking today. "Bankers' plight versus consultants' delight" could well be the headline that summarises risk management scenario in many banks.

No doubt, thanks to the combined efforts and inputs of all stakeholders, Risk Management has evolved and evolved rapidly into a full fledged discipline in its own right, but are we there yet? The honest answer is 'No'. Risk function therefore is set to develop and evolve as years go by.

Looking into the crystal ball

In view of the prevailing scenario in banking, what's next is a natural question to ask. How does the ecosystem steer banks to safety and stability? One approach could be to convert banks into utilities, but others could argue that a ship may be safe in harbour, but that's not what ships are built for. Risk function must find ways to support the voyage better. Crystal balling into the next decade, one can list out a range of issues, approaches and ideas that would occupy Risk professionals. Here are the Top Twelve strands that might define the risk management landscape in banking:

i. The buy-in for what Risk function does would considerably improve. The 'tone at the top' is already set by the leading CEO's and the next decade would see it percolate down to the last mile. Going forward, Risk professionals would play a broader leadership role in the overall scheme of governance and, more importantly, in building the right culture.

ii. Hand-in-hand the regulatory overreach could also recede as BCBS tackles complexity and opts for effectiveness via simplicity. Basel has kind of already started the re-alignment, if not roll back. The Advanced Measurement Approaches (AMA) for operational risk stand withdrawn. All the three variants of the Standardised Approaches have been replaced by a newly devised Standardised Approach. It's akin to Basic Indicator Approach (BIA) in simplicity and yet augmented adequately for risk sensitivity via a concept called Internal Loss Multiplier (ILM). Credit Risk Framework too is simplified. The Advanced-Internal Rating Based (A-IRB) approach is practically out. Introduction of Input and Output floor would make the Foundation-IRB (F-IRB) approach quite akin to the standardised approach (SA) in terms of RWA levels. The new approach recognises the pitfalls of reliance on internal modelling alone. Old fashioned due diligence for credit risk is sure to supplement reliance on external ratings.

The next decade would witness the roll-out of these simplified approaches. BCBS could and perhaps would spend time streamlining, possibly further simplifying the architecture based on the experience. The lessons learnt from the progressively shorter lifespan of each Basel variant and longer time taken for roll out would likely continue to favour simplicity.

iii. Markets would probably play a greater role in funding enterprises, yet credit risk is unlikely to be dethroned from being the dominant risk that banks face. Credit would remain a capital guzzler.

iv. Risk function is likely to be spending more time managing risks and less generating data and modelling risk. Analysis and judgement will prevail over measurement as data collection will increasingly become routine. Data analytics would provide sharper insights to Risk management. Banks that develop skills in data / risk analytics would be better off.

v. The previous decade has augmented capital, reduced leverage, enhanced liquidity and improved identification, measurement and disclosure of risks. Heavy lifting has happened in creating historical databases, writing policies, drafting processes, building models, back-testing, stress testing and putting in place the

various components of the risk framework. The next decade has therefore, got the space to move away from routine 'production' to value-added goals and containment of emerging risks.

vi. We are set to grapple with elevated levels of risk in terms of cyber challenges, technology, data leakage, talent availability and, possibly, a few more risks that are still in formative stages. Digital threats could be a recurrent challenge. So called 'black swans' might also manifest more frequently as an outcome of butterfly effects, digital ecosystem and yet unknown risks, raising demanding asks in terms of long term and yet agile risk management practices. Disaster Recovery (DR) and Business Continuity Plans (BCP) may acquire an altogether new dimension. Developments in the currency arena, including potential currency wars and crypto currencies gaining currency under Central Bank aegis, could lead to exciting times in market risk management practices as well. With data turning into a hot commodity, privacy concerns will call for effective safeguards against any leakage. Data protection, a la General Data Protection Regulation (GDPR) in Europe, is likely to emerge as a major theme soon. It is time risk function started studying and preparing for these risks.

vii. Reputation Risk in the context of the always-on information culture would likely acquire zero tolerance in its true sense. Risk-Reward equations might take a back seat when it comes to preventing reputation incidents. Next decade is sure to witness sharper action on this front. Banks would do well to remind their staff that the Internet never forgets. Right conduct is critical, each time and every time.

viii. Risk function would move beyond measurement and quantification of capital charge to explore, suggest and generate buy-ins for improvements in risk management by Line I. Risk is best managed where it originates. Risk function would therefore, need to invest in creating a sharper risk awareness among business verticals. As a Line II function, risk is well positioned to create a feedback loop that regularly pipes actionable insights and foresights into risk originating business units for follow-on action.

ix. Line III, i.e. Internal Audit currently generates a huge amount of data on deviations and control breaches that are routinely addressed by Line I and 'closed' as 'complied with'. These data points are likely to be the 'fodder' for risk to digest and come up with patterns, trends and insights that business verticals need to make processes efficient, underwrite credit better, identify and contain operational risk hotspots or manage talent risk. So look for sharper synergy between risk and audit in data flows in the next decade.

x. Another emerging synergy – the linkage between Risk and Finance would strengthen. These functions would be talking more often. With ICAAP evolving into a strategy document, it's only natural that finance consults and draws inputs from risk to drive the target ROA, RAROC and RORWA. In a broader context, the connect between Line 1 and Line 2 is also likely to improve as the perception about Line 2 as a spoilsport would change. Risk will play a major coordinating and value enhancing role.

xi. Fin Techs, Reg Techs, AI, Big Data, Chat Bots, Robotic Process Automation (RPA) and other technologies would likely help drive Risk Management costs down as also enhance risk management at scale, but banks would need to stay alert to the risks of continuing with legacy processes, harbouring surplus resources due to replication of processes across the three Lines of Business, and even drowning in data lakes. It would be critical to maintain prudence and judgement via expert overlays who are skilled at

mixing small data and big data the right way to get the right foresights. And that brings us to the biggest risk staring at us; talent risk.

xii. The best defence against risk is a knowledgeable and skilled manpower that understands how to follow processes, learn fast and exercise prudence. Risk may need to work with HR to create the content that's compact and impactful. Mantra got to be to drill the 'Need to Know' stuff into muscle memory, while digital library supports 'Nice to Know' bits. Risk function would also spend time learning 'communication' or collaborating with Internal Communication experts to spread the risk awareness across the organisation. Risk professionals will work to ensure risk sensitivity gets into the DNA of the bank's culture. That's what will drive the ROI in a sustainable way over the long term.

Conclusion

To conclude, risk management in the next decade is likely to build on the processes, policies and frame-works already in place to step up to substantive management of risks - existing, emerging and new, as against data dicing and tick-box process compliance. Collaboration and communication spanning the three lines of defence plus the platform functions would in all probability drive the building of the right operating culture and embed risk into the way a bank operates. Appetite for Reputation Risk is likely to tend to zero. Talent Risk would remain a big issue. Credit would continue to guzzle capital, but occasional high impact operational risk events may continue to surface. Technology usage in managing risk might help streamline routine processes, but might also lead to data deluge that leads to incorrect inferences, making us miss the forest for the trees. Data would remain susceptible to leakage too.

Basel reforms would most likely impose lesser complexity and better illumination. We can also expect convergence between Risk and Business functions in approaching opportunities. Risk focus is likely to invariably underpin search for revenues. Business will look for Risk-adjusted Return on Capital (RAROC) in all it does.

Risk function will be equally conscious of the ROI demands of business and, hopefully, lead the way to a scenario when all employees, to borrow a phrase from Kenny Rogers, would 'know when to walk away, and know when to run.' That's the time when Risk Management would be a source of competitive advantage.

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