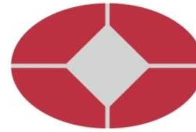

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BANK FOR INTERNATIONAL SETTLEMENTS

Basel II/III
Supervisory Risk Assessment Frameworks
Concentration and Reputational Risk

CARTAC- CCMF
Port-of-Spain, Trinidad and Tobago
19-20 March 2015

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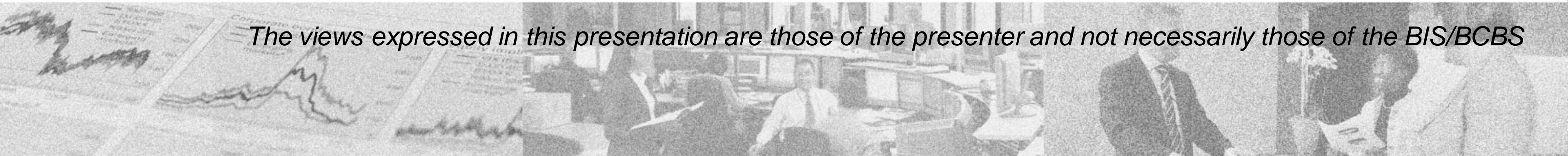

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Outline

- Supervisory Review Process:
  - Pre-conditions
  - Powers, resources, protections
- Four Pillar 2 Principles and their meaning
- Pillar 2 Enhancements
- Risk concentrations
- Reputational risks

1 - The "tone from the top"…

".. something is seriously awry when.. the Financial Services Authority that was established to provide clear guidelines and rules for the financial services sector and to protect the consumer against the fraudulent, is seen as hugely inhibiting of efficient business by perfectly respectable companies .."

Tony Blair, 26 May 2005 speech to Institute of Public Policy Research

" The then Chairman of FSA sought to correct this view by replying in a letter that the FSA was efficient..and, by way of example,..the FSA devoted only six staff to the supervision team responsible for HSBC"

The failure of the Royal Bank of Scotland, FSA Board Report

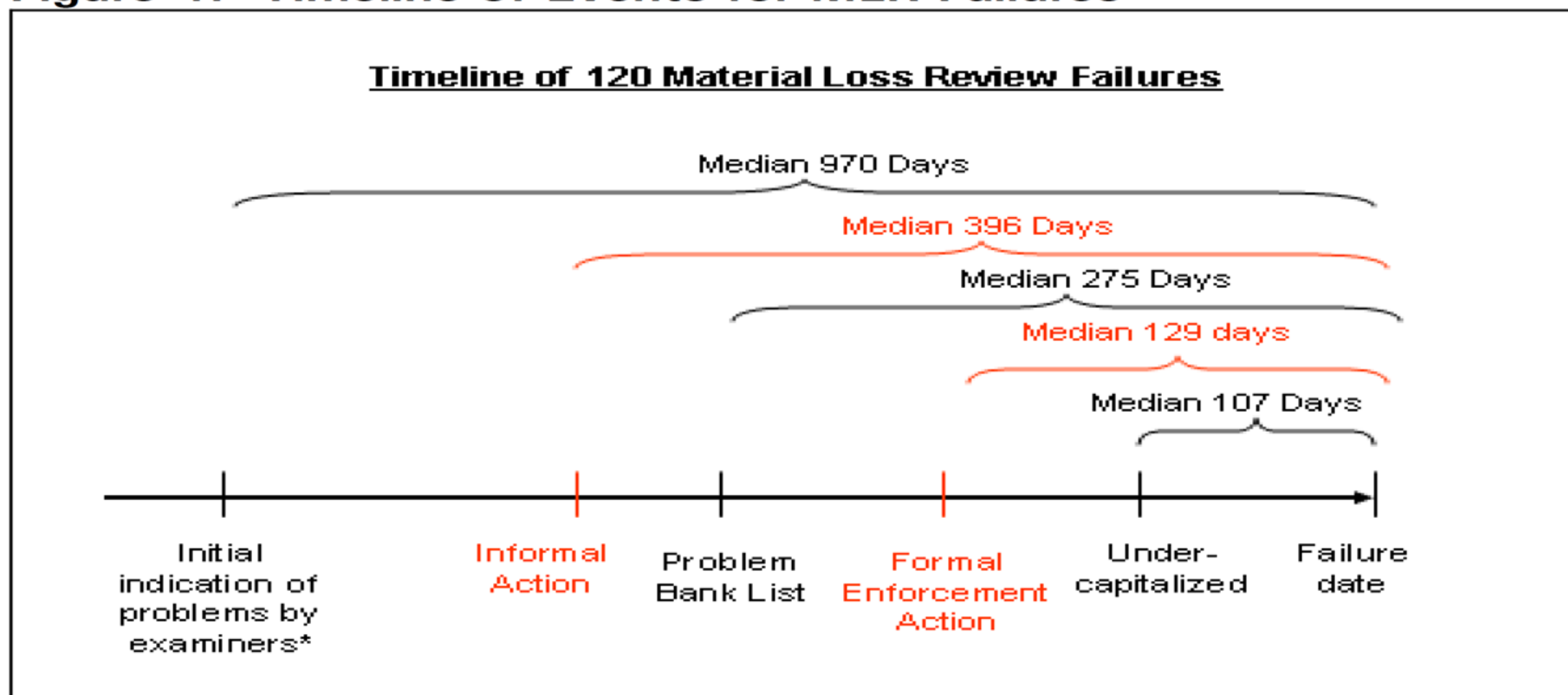
1- Role of banking supervision in the financial crisis…

- *"The (financial) crisis was avoidable. The crisis was the result of **human action and inaction**, not of Mother Nature or computer models gone haywire. The captains of finance and **the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks**"*

U.S. Financial Crisis Inquiry Commission Report, 2011

1 - In a nutshell: to little and too late…

Figure 4: Timeline of Events for MLR Failures



Source: OIG analysis of supervisory data for MLRs completed between January 2006 and March 2010.
*Initial indication of problems by examiners was generally the date of the examination in which examiners identified problems in the bank that ultimately contributed to the bank's failure.

1 – Basel Core Principles (BCPs) and pre-conditions

- The Core Principles (post-crisis version: 2012): highlight need for non-supervisory elements of financial stability to be appropriately handled
- The “preconditions” originally covered four broad areas:
  - Sound and sustainable macro-economic policies
  - A well-developed public infrastructure
  - Effective market discipline
  - An appropriate level of systemic protection (public safety net)
- Importantly, the preconditions have been revised to include:
  - a well established framework for financial stability
  - a clear framework for crisis management, recovery and resolution

1 - 'Risk-based' supervision and its implications (1)

- Risk-based supervision combines:
  - Rigorous risk assessment (~ likelihood of/proximity to failure)
  - Impact analysis (~ impact of failure)
- Structured, disciplined approach – but with 'built-in' flexibility
- Incorporates forward-looking perspective by considering:
  - Business and economic environment
  - Assessment of plausibility/viability of business model
  - Trend/direction of risk/Growth rate
  - Results of stress tests (idiosyncratic and market-wide)
- Dynamic assessment / 'continuous supervision'
- Intention: cure, where possible, or to resolve without disruption, if not
- Must enable early intervention and corrective action

1 – Independence/legal protection/powers

- Operational independence, accountability and governance structures of the supervisory authority prescribed by legislation and publicly disclosed
- Does not necessarily imply public funding if bank contributions:
  - Calculated in a transparent and objective way
  - Give no right whatsoever and no oversight powers to the contributors
  - Seen, in economic terms, as the equivalent of insurance premiums
- Institutional independence and legal protection
  - From both supervised institutions and political pressures
  - Protection of the agency and its staff:
    - From lawsuits for actions/omissions made while discharging duties in good faith
    - From the costs of defending their actions and/or omissions
- Clear legislation and discretionary powers (e.g. business model analysis)
- Accountability "cuts both ways"
  - "Give credit where credit is due": promotion/compensation
  - Responsibility/accountability at the top motivates field staff

2 - Pillar 2: Supervisory Review Process (SRP)

- Supplements Pillar 1 which sets minimum capital requirements
  - Pillar 1 charges assume a fully diversified bank (never true) so it can only be a minimum
  - Risks not taken into account at all (IRR in banking book, strategic risk, securitisations, reputation risk)
  - External factors to the bank (e.g. macroeconomic environment)
- Purpose: better align capital requirements with risk-profile
- Fosters improvement in risk management and in supervision
- Ensures compliance with Pillar 1 requirements – both quantitative and qualitative (on an ongoing basis)
- Risks NOT included/captured in the BCF: leverage, liquidity risks
- Pillar 2 designed to trigger early intervention if capital levels do not exceed the minimum by a sufficient margin
- Margin above the minimum requirements supposed to reflect ALL risks and quality of risk management (and tailor-made?)

2 - Pillar 2: The Four Principles

A quick recap….but not the full story

1. Bank's own assessment of capital adequacy (ICAAP)
2. Supervisory review process (SREP)
3. Maintaining capital above regulatory minima
4. Supervisory intervention

2.1 – ICAAP & SREP

- A disciplined <u>process</u> that relates capital to the level of risk and:
  - that states capital adequacy goals vis-à-vis risk, considering the bank's strategy and business plan
  - that accounts for the bank's risk management, internal controls, reviews, and audit
- Policies and procedures in place to ensure that the bank identifies, measures, monitors and controls all material risks
- Subject to board oversight, driven by senior management, bank-specific
- SREP to establish whether:
  - all material risks captured, assessed and included
  - governance arrangements and internal controls are adequate
  - risk measurement methodologies are reliable

2.3 and 2.4 – Operating above minimum levels

- Initial principles 3 and 4: ensure that
  - All banks operate above 8%
  - Supervisors intervene as soon as ratio starts to decline
- With Basel III, concept of "minimum level" has evolved
  - Pillar 1 minimum levels have increased (CET1 > 4.5%, Tier 1 > 6%)
  - Addition of supervisory buffers or surcharges which, given the penalties for non-compliance, become "de facto" minimums (capital conservation and countercyclical buffers and SIB surcharge)
  - Pillar 2 buffer additional to account for bank's idiosyncratic risk profile
- Early supervisory intervention: to take place earlier?
  - More intrusive, intensive, effective supervision
  - Supervisory intervention before capital ratio starts to decline
  - Questioning/challenging bank on its business model, its business strategy, its funding strategy etc… not only its yearly capital planning

3 - 2009 "Pillar 2 Enhancements"

- Part of the response of the Basel Committee to the financial crisis
- Immediate implementation expected for Pillar 2 elements
- Insistence of firm-wide risk oversight (multiple focused initiatives)
- Specific risk management areas:
  - Risk concentrations,
  - Off-balance sheet exposures - focus on securitisation,
  - Reputational risk,
  - Valuation practices,
  - Liquidity risk management,
  - Stress testing practices,
  - Compensation practices

3 - Firm-wide Risk Oversight

- Management must have an integrated, firm-wide view of bank's exposures
- Linked to growth in banks' capital markets activities and to recognition of globally systemically important banks (G-SIBs)
- Different areas of a bank may be exposed to a common set of products, risk factors or counterparties (e.g. exposure to real estate prices)
- Risk management processes must consider ALL material risks, not only credit, market, liquidity and operational risks
- Growing importance of reputational, legal and strategic risks
- Features for sound firm-wide risk management framework
  - Active board and senior management oversight
  - Rigorous (and rigorously enforced) policies, procedures and limits
  - Comprehensive and timely identification, measurement, mitigation, control, monitoring and reporting of risks
  - Quality of management information systems
  - Comprehensive internal controls

4 - Risk Concentrations

- Not covered by capital standards (risk-based or leverage ratios)
- Can threaten a bank's future
- Credit concentrations arise in multiple ways including:
  - Single counterparties and groups of connected counterparties both direct and indirect (exposure to collateral or to credit protection)
  - Specific sectors, geographic areas (countries, regions)
  - Specific risk factors (real estate prices, foreign exchange…)
  - Market risk concentrations: bank overly exposed to particular asset classes, products, collateral, currencies
  - Funding concentrations
- «Hidden» risk concentrations:
  - Those that are not apparent when considering risk types separately
  - Those that emerge during stress periods (hence stress testing)
- What are the main risk concentrations for banks in the region?

4 - Tools for Managing Concentration Risk

- Supervisory assessment of management of its risk concentrations
- Measuring/assessing concentrations
  - Using multiple metrics, e.g. gross vs net exposures, use of notional amounts (e.g. for derivatives), exposures with and without CRM
  - Risk assessment techniques: sensitivity analysis, scenario analysis, economic capital models
  - Stress testing to assess impact of concentrations (changes in correlations between exposures, risk types, risk factors)
- Managing risk concentrations
  - Internal position/counterpart/product limits: for both assets & funding
  - Risk mitigation (buying protection, collateral, syndication, reserve of liquid assets, available liquidity facilities)
- Capital surcharges for risk concentrations incorporated in bank's ICAAP
- Standard for large exposures – single counterparts (25% / 15%)

5 - Multi-form Reputational Risk

- *'Risk arising from negative perception on the part of customers, counterparties, shareholders and other stakeholders that can adversely affect a bank's ability to maintain normal business practice'*
- Banks should identify:
  - potential sources of reputational risk (e.g. from overseas operations, from involvement in securitisation)
  - instances where a bank will go beyond its contractual obligations to protect its market reputation (i.e. implicit support)
  - effect of reputational risk on ability to source for funding
- Included and assessed in ICAAP & liquidity contingency plans
- «New» form of reputational risk since 2008:
  - Failures in IT systems
  - «Conduct costs»: huge fines for various «malpractices» and to avoid prosecution – about USD 200 bil. paid out since 2008 and counting
  - Impact on customers more difficult to quantify but can be significiant

Guidance and standards: a few recent developments

- BCBS
  - The internal audit function in banks (Jun 2012)
  - Principles for effective risk data aggregation and risk reporting (Jan 2013)
  - A sound capital planning process: fundamental elements (Jan 2014)
  - Supervisory framework for measuring and controlling large exposures (April 2014)
  - Supervisory guidelines for identifying and dealing with weak banks (June 2014 – Consultative Document)
  - Review of the Principles for the Sound Management of Operational Risk (Oct 2014)
  - Corporate governance principles for banks - CP (Oct 2014)

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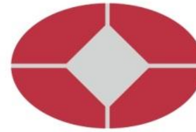

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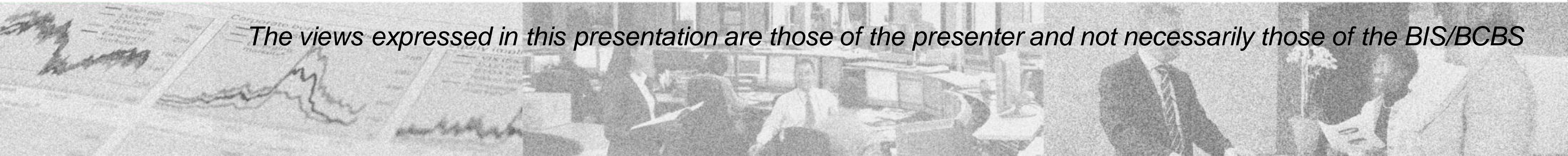

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