Bank Governance Leadership Network
ViewPoints
March 26, 2012
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Top and emerging risks for global banking

During two days of discussion on February 15 in New York and February 29 in London, participants in the Bank Governance Leadership Network (BGLN) met to discuss ways to improve risk identification, implications of the eurozone crisis, and top and emerging risks in global banking. Michael Alix (senior vice president, Federal Reserve Bank of New York), Michael Brosnan (senior deputy comptroller, Office of the Comptroller of the Currency), and Ted Price (deputy superintendent, Office of the Superintendent of Financial Institutions) attended the New York meeting. Lyndon Nelson (director, Risk Management Division, Financial Services Authority) attended the London meeting. In aggregate, eight chief risk officers and six non-executive directors from 12 global banks attended these meetings.

This *ViewPoints* synthesizes the perspectives and ideas arising in the meeting discussions on top and emerging risks, as well as in nearly 50 discussions before the meetings with directors, executives, supervisors, and banking professionals. [1] For participants' views on the euro crisis and on improving risk identification, see *ViewPoints*, "Implications of the Eurozone Crisis," and "Improving Risk Identification."

Those risks can be clustered into four categories relating to (1) funding and liquidity, (2) regulatory changes (3) cybersecurity and other geopolitical risks, and (4) the general economic picture:

- **Bank funding, liquidity, and collateral management remains a concern** *(page 2)*. Much effort has been expended globally to decrease systemic risk in banking by enhancing capital and liquidity requirements. These measures themselves are among the reasons that funding and liquidity remain near or at the top of many risk officers' and directors' risk lists.
- **Regulatory changes around the globe are introducing new strategic, operational, and potentially systemic risks** *(page 3)*. Participants highlighted several concerns: (1) the consequences of uncoordinated and insufficiently analyzed changes in regulation and supervision, (2) new systemic risks arising from regulation, (3) the impact on bank business models, risk profiles, and resultant bubbles, and (4) enhanced consumer protection and associated litigation risks
- **Cybersecurity and other geopolitical risks present unique oversight challenges** *(page 8)*. Bank risk officers, directors, and supervisors are finding that they must pay increasing attention to geopolitical risks, including the risk of cyberattacks from both state and non-state players.
- **Economic and market conditions continue to pose both short- and long-term risks** *(page 10)*. Participants expressed concern over the consequences of a prolonged low-growth, low-rate economic environment, including the associated risks of loss of talent during the current industry upheaval and fatigue and operational risks from the sheer amount of change.

[1] All discussions were held under a modified version of the Chatham House Rule that encourages sharing of perspectives but absolutely forbids attribution to individuals or institutions. All comments from participants are italicized. A complete list of participants can be found in the Appendix 1, on page 14. A complete list of interviewees can be found in Appendix 2, on page 15.

Bank funding, liquidity, and collateral management remains a concern

Through the coordinated efforts of the Basel Committee and individual countries' changes to capital and liquidity standards, banks' capital and liquidity positions have improved significantly from 2008–2009. This has reduced systemic risks, though by how much remains a point of argument.

Meanwhile, market confidence remains fragile. One CRO observed that *"anything that affects funding and liquidity in the next couple of years … is a risk."* Participants noted three risks in particular:

- **Funding shortages when new capital is required.** One CRO said, *"The ability of the financial system to fund itself the longer the crisis continues, combined with more and more stringent rules on funding, is a risk."* Solvency II may curtail insurers' appetite for bank debt and force insurers to raise new capital at the same time that banks need to in order to implement Basel III. [See below for more on the interplay between regulations] Other sources of funding are also in doubt: one CRO asked, *"What happens to European banks' balance sheets if US money market funds stay away from European banks?"*
- **The continuing liquidity challenge.** A director asked, *"Who is the provider of liquidity? Liquidity risk management is an art and an integral part of capital planning. We are beginning to understand the strategic importance. Treasury is a permanent part of risk committee meetings … Even solvent institutions that are illiquid go bankrupt."* A director noted that as a result of the role the European Central Bank (ECB) and national central banks have played providing market liquidity, *"risk is being transferred to central banks, and with Solvency II and Basel III, financial institutions cannot take that risk back. We are faced with a very dangerous systemic risk if something were to happen."* Many remain concerned that the ECB won't act as the lender of last resort even though that is *"the whole rationale behind having a central bank."*
- **Collateral management as a result of ratings triggers.** In February, Moody's Investor Services launched a review of the ratings of 114 banks across Europe and an additional 17 global banks and securities firms.[2] A CRO stated, *"Some banks are bound to be downgraded, and it is unclear what will happen to collateral triggers and things as a consequence."* Political talk about denying future bailouts of large financial institutions could be exacerbating this issue, according to one director who commented, *"Ratings agencies used to give a step up [to banks' ratings] because of governments as the lender of last resort. Now, governments are saying they will not bail out financial institutions, so ratings must get reduced even if governments will ultimately bail out financial institutions."* Participants warned about the potential consequences of downgrades. One CRO said, *"If a number of banks are downgraded … collateral demands could be material. There will be a tremendous pull on bank treasuries."* After the meetings, one CRO said, *"There will be winners and losers, and we are actively trying to determine where we will end up on negotiations, as will others, on collateral issues."*

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[2] Moody's Investor Services, "Rating Action: Moody's Reviews Ratings for European Banks," February 15, 2012.

Regulatory changes around the globe are introducing new strategic, operational, and potentially systemic risks

Participants in the BGLN have routinely discussed the ongoing regulatory and supervisory changes that are taking place globally. Without doubt, the current changes are unprecedented, and the extent of their effect will only become clear in years to come. Participants outlined several regulation-related risks that are already emerging:

Consequences of uncoordinated and insufficiently analyzed changes in regulation and supervision

The scope and intensity of industry regulation have increased to an unprecedented degree following the financial crisis. The advent of Basel III, Solvency II, Dodd-Frank, the Volcker Rule, and the Consumer Financial Protection Bureau (CFPB), along with the actions of the European Banking Authority (EBA), the Independent Commission on Banking, and national supervisors have resulted in a tsunami of regulations for banks and their boards to handle. Compounding the difficulty is the fact that many of the regulations and their implementation are as yet unsettled: the practical interpretation of the Volcker Rule is unresolved; the scope and enforcement model of the CFPB is in early stages of development; the details of Dodd-Frank are still being written; and the Financial Services Authority (FSA) is on the cusp of splitting into two entities under separate mandates.

Most participants acknowledged that a revamp and expansion of regulation and supervision was necessary coming out of the financial crisis, and the capital and liquidity levels of individual banks have improved as a result. However, since the amount of regulation has increased and coordination among supervisors has been less than complete, the discussion centered on the potential for unintended consequences and the effects of all the regulations in aggregate. One participant noted, *"We collectively should not put too much blame on others. We need to be much more practical and not defensive."*

Participants expressed four major concerns in this area:

- **No one has fully analyzed the aggregate impact of regulatory change.** While the effects of individual elements of regulatory change have been modeled, the aggregate impact of the range of new regulations is unknown. What will be the aggregate systemic effect of so much regulatory change in such a short period of time? As one participant observed, *"There is an absence of a balanced discussion at the authorities. Trade-offs are not fully balanced. Some cost-benefit analysis has not been done. Some cannot be done."*

- **There is insufficient analysis of the interplay between disparate regulations.** Many directors and CROs were worried about how the various new regulations will impact one another. Of particular concern is the simultaneous implementation of new structural regulations like Basel III and Solvency II, which may significantly curtail the ability of banks and insurance companies to provide sources of capital both to the economy and to each other. Said one director, *"Solvency II and Basel III together may lead to banks not getting funding from insurance and vice versa. No one is making the linkages."* Other examples exist. Stated one director, *"We do a lot of hedging for companies. If we're sufficiently* *penalized on [Basel-related capital value adjustments], we may not be able to offer the same services to small and medium enterprises at below scale."*

- **Regulation is highly fragmented and uncoordinated both within and across national borders.** This was one of participants' most common complaints. Problems with fragmentation and lack of coordination are most acute for global banks. There is a natural tension between the regulation of these entities as going concerns across national borders and regulations requiring banks to meet certain prudential standards in their home domiciles – these latter being designed to assure the state is not put in the position of having to rescue the bank using sovereign resources. As one observed, *"All regulators are nationalistic. [Banks] are global in life and local in death."*

  While agreeing on the need for a new regulatory model to ensure safety and soundness, banks find the current fragmented and uncoordinated implementation to be inefficient, overly distracting, and sometimes at cross-purposes to the regulator's intent. One participant noted, *"We still get too many requests for information. I try to engage in a dialogue about what they want from the information, so I can ensure we respond appropriately. But even so, we have no choice but to produce what they want. Regulators may have good reasons for the tight deadlines that they set for their demands, but the high level of demands is creating real operational risk."* Another participant said, *"We set out a glide path for Basel III … then out of the blue the EBA says we need to be at 9% capital within six months."* In the near term, there seems to be little hope for significant coordination. As one of the participating supervisors explained, in the short term, *"We are not going to coordinate our exams [with other supervisors] around the world; it is just not feasible."*

- **There is uncertainty regarding regulatory intervention during crises.** Regulators in numerous regions have developed rules and contingency plans (e.g., resolution and recovery plans, ring fencing) to be implemented in the event of systemic risk triggers. As the scope and depth of these contingency requirements increases, regulators become important new actors in the aggregate market reaction to systemic risks. As one participant noted, *"When a crisis happens, [regulators] will all start ring fencing."* Global regulators' lack of awareness of their counterparts' contingency plans introduces new forms of uncertainty about how the market will perform when faced with a potential systemic event. Another participant asked, *"When do you decide to tell your banks to stop dealing with another global bank? We always say we should get ahead of it. It's not just the banks – there are other key intermediaries. What are the points of stress, and how do we actually deal with them as a system?"*

New systemic risks arising from regulation

Many of the new regulations are designed to define, identify, and regulate systemically important financial institutions (SIFIs) to avoid another crisis involving state-funded rescues of failing institutions. Discussion participants felt that although important progress has been made, some of the new regulations may inadvertently exacerbate too-big-to-fail concerns or create new, unexpected SIFIs:

- **Creation of new systemically important organizations.** One of the primary conclusions drawn from the recent financial distress was that aggregate risk exposures should be more transparent. As a result, some risk-based activities, such as counterparty transactions, will now go through new clearinghouses. These institutions can reduce risk by providing greater transparency and clarity regarding aggregate risk exposures, but at the same time, reliance on them as single-point institutions may contribute to new forms of systemic risk. As one supervisor pointed out, *"You are substituting one vulnerability for another."*

- **Unintended consequences of SIFI designations.** Participants noted that as new regulations impose higher fixed operating costs on financial institutions, the resulting economies of scale could result in an industry populated by fewer, larger organizations. Noted one director, *"The industry structure will be affected. Only a small number of well-financed organizations will emerge."* Participants pointed out that if a bright-line size threshold is used to define SIFIs, then many institutions will cluster just below the demarcation, where they are not classified as SIFIs, but may still require collective support by the state during a significant systemic event. One member asked, *"If many medium-sized banks all have the same problem at the same time, can the regulators afford to let them fail simultaneously?"* The considerable difficulty of regulating a global SIFI through multiple local regulatory authorities was also highlighted. A minority said that SIFI status could result in a lower cost of capital, conveying an advantage to SIFIs and fueling their growth. Furthermore, during less stable periods leading up to a systemic event, capital would likely gravitate to SIFIs for safety, thereby increasing the required scale of any regulatory or state assistance, should it occur.

- **Migration of activities into shadow banking without adequate decoupling of banks' exposures to these adjacent sectors.** Stricter regulation of financial institutions' activities may cause some banking activity to migrate to different lines of business, new geographic areas, or different product types that are less regulated. A lead regulator noted, *"We are still trying to determine where the real risks are. It's not hedge funds. It's [instruments such as] net-asset-value money market funds, or in areas of maturity transformation."* The Financial Stability Board, on behalf of the Group of 20 member states, is currently reviewing the need for more active monitoring and potential regulation of elements of shadow banking. Participants in recent BGLN meetings commented that the adverse effects caused by a systemic event in shadow banking will still be experienced in the regulated sectors. One supervisor said, *"The shadow banking sector cannot exist without the connection to the regulated banking sector … I am interested in how [banks] think it will play out if more things are pushed into the shadow banking sector. [Banks] basically indirectly get exposure to risky, often profitable activities by funding shadow banking."*

The impact on bank business models, risk profiles, and resultant bubbles

Now as before the crisis, banks need to earn an attractive risk-adjusted return for their shareholders, but this is yet more difficult given new regulations, and the state of the global economy. As a result, they are exploring new lines of business, product offerings, and markets, which bring with them new sources of strategic and operational risk. One director asked, *"How will firms try to optimize against regulatory restraints? With deleveraging and rebalancing of portfolios? What does that mean? What happens?"* Another observed, *"The most important battle we are facing every day is our ability to model returns and risks on businesses given regulatory changes and new capital requirements."*

Network participants highlighted several risks associated with banks' responses to regulatory changes:

- **Evolving risk profiles.** As banks enter new markets and introduce new products, they may encounter new risks and market structures that – initially, at least – are poorly understood both by the banks and their supervisors. One participant noted, *"Many banks are contemplating a more aggressive push into asset management. Do they know what is required to be successful? Have they correctly gauged the risks and likely returns?"* A supervisor expressed concern about the implications, saying, *"Your strategy is informed by where you think you can earn the best risk-adjusted returns. That used to be sovereign debt and residential mortgages. As that shifts, what happens to returns? Do risk appetites need to evolve, and how? What new risks does that create?"*
- **Risk associated with exiting businesses.** Fundamental operational risks could emerge as banks exit businesses. One participant explained why: *"The easy part is the decision in the boardroom about what businesses you want to be in and which you want to get out of. But how do you exit a business that wasn't designed to be exited? How do you ensure legal liabilities are appropriately transferred?"* A director noted, *"If you exit a business, it is difficult to get out completely. Six months later, 20% of the business is still there, but gets limited attention, and then suddenly there is a blowout. That is a real risk we would not have talked about a year ago."*
- **Risks from new competitors.** Banks may discover that markets and clients previously the province of banking are attracting nontraditional entrants through disintermediation of banks. One member commented, *"You are starting to see asset managers explore a move into syndicated corporate loans funded by institutional investors."*
- **Threat of new bubbles.** If many financial institutions pursue the same types of new opportunities as regulators impose restrictions on existing businesses or products, bank business strategies could become more highly correlated. The resulting aggregate market pressure could both depress long-term returns as asset prices are bid up and increase systemic risks as the correlation of banks' activities rise. A supervisor said, *"Everybody's moving into the same things, then everybody gets it wrong at the same time."* One CRO warned, *"If global regulators create market distortion by discouraging some activities, pushing everyone into the same things, [that can create] a new bubble."* A director asked, *"What areas are seriously overheated? If we asked that simple question five years ago, we might have then asked, 'Well, what might happen? What are the implications?'"* A regulator suggested a review of current businesses: *"What are the businesses that have been the relative sources of strength over the last five years? In the resolution planning, what have they said they will hive off because it is valuable and they can get a lot of money for it? What are the things they have said are so good they will never sell?"*

Significantly enhanced consumer protection and associated litigation risks

At the 2011 Bank Directors Summit, bank directors discussed the challenges of serving customers and clients profitably with Elizabeth Duke, a member of the Board of Governors of the Federal Reserve System.[3]

[3] Bank Governance Leadership Network, "Global Banking Adapts to Adverse Economics and Restrictive Regulations," *ViewPoints,* November 10, 2011.

Participants said that strengthened consumer protection measures bring to fore the thorny question of fairness, both in the United States and Europe, and they worried that the trend to put protective measures in place was spreading from retail customers to high-net-worth and institutional clients.

At the recent risk meetings, consumer protection concerns came up again in three contexts:

- **Legacy costs from misselling and litigation.** The costs of litigation *"are colossal if you add them up across the industry. There is more to come, and it could be devastating,"* according to one CRO. A director agreed, saying, *"We will see further litigation. And there are things banks will do for customers who are underwater on mortgages ... Many of those things are legacy costs."* These legacy costs present challenges as banks try to move ahead with new business models and new product development. One director explained the problem: *"Consumer protection is backward looking. How can you do anything if you think you might be on the hook for $10–12 billion in lawsuit settlements?"*

- **Changing customer behavior.** Several participants worry about the long-term behavioral effects of recent settlements, particularly those associated with mortgage lending. One supervisor said, *"We have a demonization of bankers and a destigmatization of default. This will surely lead to changes in borrower behavior."*

- **Proactive product intervention, without a safe harbor.** The establishment of the United Kingdom's soon-to-be independent Financial Conduct Authority (FCA) and the new CFPB in the United States raise questions about how regulation of market conduct and consumer protection will operate in major markets. A supervisor said, *"The shift in the approach to conduct could potentially be huge. It is extremely aggressive and [increasingly focused on] taking preemptive action."* A director said, *"Executing well [and] serving customers right is getting harder … The system has been politicized."* The UK FCA has issued public statements about their intention to be more forward looking and will be armed with additional powers to intervene.[4] FCA head Martin Wheatley has outlined three situations in which product intervention may be necessary:

    - Firstly, it may be when we find inherently flawed products. This could be products that offer such poor value or have such disadvantageous features that most consumers, or certain types of consumers, are unlikely to benefit.

    - Secondly, it could be when there is widespread promotion or selling to customer groups for whom the product is unlikely to be suitable. An example here might be products where the customer can easily lose all of their money being purchased by people who are unable or unwilling to accept that risk.

[4] See for example, Martin Wheatley, "My Vision for the FCA," speech at the British Bankers' Association Conference, January 25, 2012, and Clive Adamson, "FCA Supervision," speech at the British Bankers' Association Conference, London, January 25, 2012.

- And a third example could be products where there is a strong incentive for a mis-sale. Here we are talking about instances where profitability is so great that the product is just being sold to everyone, regardless of whether it is appropriate for them, and the usual regulatory measures won't put a stop to it.[5]

Despite this proactive process, there will be no formal product approval process and no safe harbor if products are not banned in advance. A CRO noted, *"The goal posts move retrospectively: how can you run a business?"* Other participants said it seems these new regulators *"have zero risk tolerance,"* which increases banks' compliance risk. *"This will have enormous effects on business models,"* one participant said. A CRO acknowledged, *"The industry starting point is weak. We have treated customers poorly … But I think this territory is extremely dangerous. The judgment of fairness is not a science.*"

Cybersecurity and other geopolitical risks present unique oversight challenges

Directors, CROs, and supervisors find that increasingly, geopolitical risk is climbing up the risk agenda, and in particular that unique form of 21st-century geopolitical risk: cybersecurity. Cybersecurity has shot up everyone's agenda due to state-sponsored cyberattacks, the activities of anarchic hackers such as those comprising Anonymous, and the almost weekly reports of banks' losing customer data. The magnitude of the challenge is immense. As Robert Mueller, director of the Federal Bureau of Investigation, said recently, "Terrorism does remain the FBI's top priority, but in the not-too-distant future, we anticipate that the cyber threat will pose the number-one threat to our country."[6] But traditional geopolitical risks are also high on the risk agenda, thanks to political and social upheaval in the Middle East and Africa, electoral and political changes taking place in Europe and the United States, and the global rebalancing of power between the East and West.

Cybersecurity and major information technology systems upgrades

Banks manage massive amounts of data, which makes their technology requirements quite complex and makes them a target-rich environment for fraud or cyberattacks. Many large banks grew through acquisitions and as a result have pieced-together legacy systems, which require significant investment to integrate, update, and protect. Information technology (IT) is also an area in which few directors, executives, or supervisors have applicable experience and expertise, increasing the oversight challenge.

Cybersecurity is a key risk for banks and the financial system

A CRO observed, *"Every bank is unique. For us, the biggest risk truly is systems: state-sponsored cyberattacks,"* while a director said their top concern is *"Internet crime and fraud."* The cybersecurity threat to banks is particularly acute because of the amount of data they manage, the sensitivity of the data, and the potential threat to the broader financial system. The IT security threat falls into two main categories:

- **Cyberterrorism.** The greatest threats are those aimed at bringing down an institution or causing a disruption of the financial system. A CRO predicted, *"At some point, state sponsored terrorists will use*

[5] Martin Wheatley, "My Vision for the FCA."
[6] Jaclyn Jaeger, "Preparing for the Inevitable Cyber-Attack," *Compliance Week*, March 6, 2012.

this to attack countries to bring down financial systems. Causing economic panic is a pretty effective tool." The speed at which technology evolves and emerges leaves all institutions vulnerable: a regulator said a security agency identifies a new threat every nine seconds, many of which involve adaptive technologies.

- **Data loss.** One director said the loss of retail data is *"a daily occurrence,"* but can cause significant reputational damage. Another said, *"The problem is the disgruntled IT manager somewhere that can sell data."* This risk may increase *"in an environment of cost cutting,"* because *"you increase the risk that people feel disaffected."* As a result, a CRO advocated *"a whole mind-set change"* in the way banks look at systems monitoring: *"We need new controls, monitoring of the movement of data outside of the normal patterns."* Mobile devices and social media present a related risk, because information can leak out in unsecured or off-site communications or gain momentum quickly, increasing the risk of reputational damage from seemingly benign sources. *"I am worried about social media and reputation risk: your reputation can [be lost in an instant],"* warned a CRO.

Defending against these kinds of threats is not easy. As noted above, many executives have limited understanding of the nature of the threat and how to calculate the downside risk it represents, and this is even more true for directors. Whatever measures banks can take to protect themselves individually, several participants agreed with one who said, *"It is not how big your locks are, it is how do you operate, knowing [the threats] are in your systems?"* A CRO said bank management and boards should think about it in terms of risk appetite: *"You will never get [enough] protection. You need a risk appetite for the level of protection, and [you need to] determine the level of investment required to achieve the level of protection that you are comfortable with."*

Most participants agreed that though widely acknowledged, IT security threats do not receive the attention and resources they deserve. A CRO stated, *"When you compare [the spending on security threats] to spending on an army to prevent an invasion, [our current level of] investment is the equivalent of thinking we can prevent a national invasion with the Metropolitan Police and building-security guards."*

The best approach to managing IT security risk, a director said, requires *"information sharing and the government [authorities and financial institutions] to react quickly."* Coordination among banks, supervisors, and security agencies could be improved. A CRO asserted, *"This is the one area we can all work together on, and the regulators should help. We get very little dialogue with regulators about this."* According to a supervisor, some work is being done, but cooperation could be enhanced: *"We did some war-gaming on this which revealed a hesitancy among the CIOs to report attacks because of the reputational damage of admitting to being hacked. We need to get over it. The Pentagon can be hacked. Government resources are limited and stretched, so we need cooperation."*

Systems upgrades may require significant investment

A supervisor called outdated IT systems *"the biggest risk that I can do the least about"* and observed, *"In the 1960s, we built a state-of-the art system. We are still on some of it."* Participants discussed the trade-offs in managing IT investments and the related operational risks. A director described the situation: *"Your IT systems are not up to date, so you allow some work-arounds. These increase operational risk. Then, it is* *part of the investment decision: are you willing to run that risk for a period of time, or [do you] make the money available to address the broader IT issues?"*

Banks decry the investment required to keep up with regulatory requests, but one director suggested banks think more holistically about the investments required: *"Even before the meltdown, affording the technology [was] a challenge. Now, the money required for regulatory changes will crowd out innovation. Boards should force management to say, 'If we have to do this for the regulators anyway, let's make it work for the business.'"* One CRO noted, *"To the extent regulation drives investment, but is disconnected from the way you manage your business, you have a problem."* A supervisor acknowledged, *"Transition costs are huge,"* but also noted that innovation should improve efficiencies and decrease costs.

Other complex and fast-evolving geopolitical risks

Current geopolitical risks include the possibility of social and political upheaval caused by macroeconomic conditions in Europe and the United States and the potential for new conflict in the Middle East. Banks should prepare for the second- and third-order effects of some of these geopolitical scenarios. BGLN participants discussed two that are especially concerning:

- **Increasing probability of a major conflict in the Middle East.** A director said, *"Our CRO is obsessed with Iran, and I think rightly."* The risk posed by Iran's nuclear program and the potential response from within the region, coupled with US elections in November, which could impact the US response, caused one CRO to conclude that the probability of a military conflict of some kind was alarmingly high: *"If so, what happens? I think it is at least a 50% probability."*
- **Reemergence of political risk in Europe.** A CRO said, *"We could have infighting in Europe and one or two big market dislocations. If you look at the September-October time frame, a lot could happen. Greek elections are coming up. There are elections coming in France … I am not underestimating a potential blow-up in Europe."* Several participants noted that European and American politics are increasingly polarized. In a discussion after the meetings, a CRO elaborated on the concern: *"The middle ground in Europe is disappearing. There are two historical precedents that concern me: The 1930s, which saw the rise of Nazi Germany and Communist Russia, and the 1970s when we had the Red Brigades, etc. It is a material risk, so what can you do about it now, managerially? What can we do … so that we make more deliberate, conscious decisions? I do worry about translating political risk into a kind of stress test scenario."*

Economic and market conditions continue to pose both short- and long-term risks

Participants expressed concern over the collateral damage, including the risk of talent flight and sheer exhaustion, caused by the current economic situation.

Prolonged low-growth, low-rate economic environment

As central banks continue to pursue stimulative monetary policy, and households, corporations, and governments continue a multiyear deleveraging, there is a risk that the present low-rate, low-growth environment will persist for many more years. Before the meetings, one participant asked, "What does it mean to operate in a prolonged period of low interest rates? How does it affect portfolio lending and trading activities?"

Higher capital requirements can result in a short-term restriction of available capital in the economy, and at higher rates of interest, may create an additional constraint on the longer-term growth rate potential of the macroeconomy, or may tip the broader economy into a new recession. One CRO said, *"My … concern is that regulatory enforcement of more capital for the banks will have a procyclical effect … They are forcing more capital on everyone when banks are in dire straits … It might provoke exactly what they are trying to avoid … They are putting a haircut on government bonds at the same time that capital needs are increasing."* Quantitative easing could ultimately lead to *"a chain of consequences"* that includes higher inflation, which would cause interest rates to rise, demand to fall, and income to fall, all exacerbating low-growth expectations. Regulatory intervention could also impact financial markets and the availability of credit.

If economies underperform for many years due to a low-growth environment, highly indebted countries will be unable to improve debt ratios through growth, causing the market value of sovereign debt held on bank balance sheets to shrink. A CRO asked, *"Will we simply enter a period of subpar growth? Will it be as benign as that, or will we see fundamental structural changes in society? Will we see a further shift in the global balance of economic power? Will we see a submergence of parts of Europe?"* A CRO at one meeting expressed real concerns about the continued *"deleveraging across Europe."*

Loss of talent while the industry goes through major transformation

Participants suggested that the industry may be heading toward a new *"banking-as-utility"* equilibrium of simpler products, higher capital reserves, lower risk, more encumbered balance sheets, and lower resulting returns, similar to the situation in the 1950s. One director said, *"Expected return on equity [ROE] of anything more than 15% is the sign of a problem,"* while a CRO asked, *"If we're down to expected ROE of 9–11%, then where do we stop? Cost of capital is 11–12%. If we're down to 6–9%, then the game becomes about restraining costs. For cost synergies, you need scale."* Another director noted, *"If we're going to 7% ROEs, as some think, [the industry] has to be smaller – more like the 1950s, and with lower [loan-to-value] ratios."*

The series of crises impacting the financial services industry and the massive changes under way could take a toll on the industry's ability to attract and retain top talent. One CRO observed, "*The transition to a lower-risk, lower-return utility model is quite tricky. It will call for extraordinary management skills. Yet, the opposite is happening – talent is being driven out of the industry. People at the top are getting bashed: to what extent and for how long do you put up with it?"* A director concurred, saying senior management is under significant strain: *"The level of stress within financial institutions is a real concern. Management is extremely stressed, and it leads to breakdowns, as we have seen."*

Participants voiced concerns about the longer-term effects of more political, regulatory, and supervisory intervention on compensation. A director described the unresolved compensation challenge and related risks: *"The idea is [that] compensation should come down from its peaks prior to the financial crisis ...*

So the impact will be enormous … Will changes in compensation be global or local at the start? It gets back to the level-playing field issue; it can create discrepancies across countries." One CRO said, *"There are few new jobs being created in the industry, and who would want to come in with compensation in doubt, given the public image of the industry? If you have options, why come into banking?"* A director said before the meetings that his board views long-term talent issues as a major risk: "*What happens if we are no longer the employer of choice?"*

Participants also worry about whether supervisors have the ability to attract and retain the necessary talent. The creation of so many new regulations has increased staffing needs at regulatory organizations, creating challenges for recruiting, training, integrating, and deploying new high-quality staff as the organizations struggle to implement new policies, many for the first time. As one participant noted, *"Many regulatory staff are making the biggest decisions of their lives on a day-by-day basis."*

Fatigue and operational risks from sheer amount of change

One meeting participant summed up the views of others when he stated, *"I worry about the sheer amount of change that is taking place across the industry … IT, people, organizational structures … It is causing a sense of overload on banks, with too much stress across the firms."*

Within banks, several developments are also pushing operational risks up the agenda. These include shifts in business models, movement into scale economy businesses, cost cuts that complicate firms' abilities to maintain appropriate risk and control functions, ever-growing political and regulatory attention on operational processes such as mortgage handling and anti–money laundering, new consumer protection rules, and outdated IT systems. One participant noted, *"You get to a point where the institution can't handle the amount of change and is forced to slap it together."*

In a conversation prior to the meetings, a supervisor said, *"The risk of the reconfiguration of the industry and its infrastructure is understated … Operational transformation is a real challenge."* As banks shift their business mix, *"the proportion of risk taken by investment banks from market and credit risk is shifting to operational risk, to more logistics-intensive businesses. Banks are focusing less on proprietary businesses and more on volume-driven [ones]."*

A CRO noted, *"We have internal and external headwinds,"* and said that as a result, *"every bank is now looking at the only thing they can control: their costs."* But regulatory requests combined with business changes mean that *"people are getting stretched, and you have to prioritize."* People being stretched increases the risk of errors, including compliance slipups. A director said, *"I have never seen a compliance issue that didn't come from an operational error."* Moves into new businesses also cause compliance risks. For example, one CRO said, *"What you are seeing is a lot of players looking to manage businesses like wealth management that are light in risk consumption, so we're seeing competition for talent … We may see people moving quickly to bring on client advisers, which calls into question the ability to properly vet the advisers."*

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Bank Governance Leadership Network
ViewPoints

Banks are trying to keep track of macroeconomic, geopolitical, and operational risks, all while complying with new regulations, adapting to a rapidly changing environment, and maintaining profitability. Handling the array of new risks and ensuring their institutions thrive will require creativity and stamina on the part of executives and directors alike.

About this document

The Bank Governance Leadership Network (BGLN) addresses key issues facing complex global banks. Its primary focus is the non-executive director, but it also engages members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of the mission to build strong, enduring, and trustworthy banking institutions.

The BGLN is organized and led by Tapestry Networks with the active support and engagement of Ernst & Young as part of its continuing commitment to board effectiveness and good governance. Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead. Ernst & Young is a global leader in assurance, tax, transaction, and advisory services to the banking industry.

ViewPoints aims to capture the essence of the BGLN discussion and associated research; it is produced by Tapestry Networks. Anyone who receives *ViewPoints* is encouraged to share it with those in their own network. The more board members, members of senior management, advisers, and stakeholders who become engaged in this dialogue, the more value will be created for all.

Appendix 1: Meeting attendees

February 15 meeting attendees

- Michael Alix, Senior Vice President, Federal Reserve Bank of New York
- Michael Brosnan, Senior Deputy Comptroller, Office of the Comptroller of Currency
- Morten Friis, Chief Risk Officer, RBC
- Keishi Hotsuki, Chief Risk Officer, Morgan Stanley
- Karen Maidment, Director, TD Bank
- F. Edward Price, Deputy Superintendent, Office of the Superintendent of Financial Institutions
- Catherine Rein, Audit Committee Chair, BNY Mellon
- Brian Rogan, Chief Risk Officer, BNY Mellon
- Anthony Santomero, Risk Management and Finance Committee Chair, Citigroup

February 29 meeting attendees

- Nathan Bostock, Head of Restructuring and Risk, RBS
- Juan Colombás, Chief Risk Officer, Lloyds Banking Group
- Sir Howard Davies, Risk Committee Chair, Morgan Stanley
- Karl Guha, Chief Risk Officer, UniCredit
- Marc Moses, Chief Risk Officer, HSBC
- Lyndon Nelson, Director, Risk Management Division, Financial Services Authority
- Benoît Ottenwaelter, Chief Risk Officer, Société Générale
- Anton van Rossum, Director, Credit Suisse
- Anthony Wyand, Audit, Internal Control, and Risk Committee Chair, Société Générale and Internal Controls and Risk Committee Chair, UniCredit

Appendix 2: Interviewees

In addition to the meeting participants, during January and March 2012, Tapestry Networks and Ernst & Young have engaged 49 risk officers, non-executive directors, supervisors, and banking professionals in discussions regarding top and emerging risks. Interviewees included:

Directors and executives

BNY Mellon

- Nicholas Donofrio, Risk Committee Chair, Executive Committee Member, Corporate Social Responsibility Committee Member

CIBC

- Gary Colter, Corporate Governance Committee Chair, Management Resources and Compensation Committee Member
- Nicholas Le Pan, Risk Management Committee Chair, Corporate Governance Committee Member

Credit Suisse

- Tobias Guldimann, Chief Risk Officer, Executive Board Member

ICBC

- Sir Callum McCarthy, Strategy Committee Member, Risk Committee Member, Nominations Committee Member

ING

- Joost Kuiper, Audit Committee Chair
- Wilfred Nagel, Chief Risk Officer

JPMorgan Chase

- Sally Dewar, Managing Director, International Regulatory Risk

Lloyds Banking Group

- David Roberts, Risk Committee Chair

Morgan Stanley

- C. Robert Kidder, Lead Director, Compensation Management Development and Succession Committee Member, Nominating and Governance Committee Member
- Donald Nicolaisen, Audit Committee Chair, Compensation Management Development and Succession Committee Member

Rabobank

- Marinus Minderhoud, Audit, Compliance and Risk Committee Chair, Supervisory Board Member

RBS

- Sir Sandy Crombie, Senior Independent Director, Group Sustainability Committee Chair, Risk Committee Member

Société Générale

- Nathalie Rachou, Audit, Internal Control and Risk Committee Member

TD Bank

- Mark Chauvin, Chief Risk Officer
- Brian Levitt, Chairman of the Board, Corporate Governance Committee Chair, Human Resources Committee Member

UBS

- Philip Lofts, Group Chief Risk Officer, Group Executive Board Member

- David Sidwell, Senior Independent Director, Risk Committee Chair, Strategy Committee Member

U.S. Bancorp

- Olivia Kirtley, Audit Committee Chair, Executive Committee Member, Governance Committee Member
- Jerry Levin, Compensation and Human Resources Chair, Executive Committee Member, Governance Committee Member

Regulators, supervisors, and policymakers

Federal Reserve Bank of New York

- Sarah Dahlgren, Executive Vice President, Financial Institutions Supervision Group
- Steven Manzari, Senior Vice President, Financial Supervisions Group

Financial Services Authority

- Andrew Bailey, Deputy Head of the Prudential Business Unit, Director of UK Banks and Building Societies

Swiss Financial Market Supervisory Authority FINMA

- Mark Branson, Head of the Banks Division

Ernst & Young

- Andy Baldwin, Sub-area Managing Partner, EMEIA Financial Services
- Chris Bowles, Partner, UK Financial Services Risk Management Lead
- Tom Campanile, Partner, Enterprise Risk Management, Financial Services
- Carmine DiSibio, Vice Chair and Managing Partner, Financial Services
- Patricia Jackson, Head of Prudential Advisory Practice, EMEIA Financial Services
- John Liver, Partner, Financial Services Advisory
- Marcel van Loo, Banking & Capital Markets Leader, EMEIA Financial Services
- Lawrence Prybylski, Global Practice Leader, Financial Services Risk Management
- Chris Richardson, Director, Financial Services
- Tim Rooke, Partner, Risk Advisory Services, EMEIA Financial Services
- William Schlich, Global Banking & Capital Markets Leader, Financial Services
- David Scott, Senior Manager, Financial Services Risk Management
- Donald Vangel, Adviser, Regulatory Affairs, Office of the Chairman