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# Meeting supervisory expectations: four questions banks must answer in 2016

As banks start the new year, they face an ongoing and formidable challenge: how to create a strategy and how to design, implement and manage a business model that meets growing supervisory expectations.

In 2016, supervisors will expect banks to answer four big questions:

- Are you resilient?
- Do you conduct yourself correctly?
- Do you have the right governance?
- Are you resolvable?

These questions are not new. Indeed, they bear a high degree of similarity to last year's. What's new is what it will take to meet supervisors' expectations: not only must a bank's ratios be right, but so must its governance, systems and controls. These must be rigorous, embedded into business as usual and based on relevant, accurate and timely data so that the bank can apply analytics to anticipate, mitigate and manage risk.

## Are you resilient?

While much of the post-crisis regulatory agenda, including revisions to the capital standards and the newly introduced liquidity regulations (Liquidity Coverage Ratio – [LCR] and Net Stable Funding Ratio – [NSFR]) are well-established and being implemented, a core challenge that firms face in setting strategy is that they are sitting on shifting sands in terms of the minimum capital requirements they must meet. The Basel Committee is still working through unfinished business following the finalization of Basel III. Agreement on Fundamental Review of Trading Book (FRTB) requirements has been reached, but firms cannot yet be certain about the full implications for different desks/positions.[1] Many other areas remain to be finalized – credit valuation adjustment (CVA), standardized floors, the standardized approach for credit risk, changes to models for credit risk and operational risk

[1] For detailed discussion on capital requirements, see GRN (2016, forthcoming), "Basel Capital Requirements – where are they heading post-finalization of FRTB and other announcements?"

and simpler approaches for operational risk. The net effect is to drive requirements steadily higher. Over and above this, the gone-concern loss-absorbing capacity, in conjunction with resolution reform (see “Are you resolvable?” below), adds to capital required and costs.

Prospectively, banks will also have to grapple with greater constraints on the use of internal models to determine risk weights for credit exposures and face the prospect that the standardized approach will serve as a floor for minimum requirements. Although the changes under the to-do list will not officially be labeled Basel IV (in actuality, these are too piecemeal to form a coherent new standard), they are very significant in scope and impact, and they will require banks to undertake extensive implementation projects. Further change is being driven by the accounting standards under IASB with the adoption of expected loss provisioning.

Beyond this is the role of stress testing. In many jurisdictions, supervisory stress tests are complementary measures that ensure capital and liquidity are sufficient, but in some jurisdictions, stress tests are effectively driving capital and liquidity requirements. Stress tests aim to ensure that banks have sufficient capital and liquidity to withstand the losses and loss of funding they might incur in the future, if the macroeconomic or market environment were to become markedly more adverse. Before a bank in one of the stricter jurisdictions (e.g., US, UK) can pay dividends or make distributions, the bank must not only meet all minimum capital and liquidity requirements and satisfy all buffers (systemic surcharge, capital conservation buffer, countercyclical buffer and any bank-specific supervisory buffer) but also demonstrate that it can continue to meet these key thresholds under stress. If the bank falls significantly below that standard, it must raise new capital and/or shrink its business. By defining the threshold in terms of the fully implemented Basel III ratios and/or setting thresholds higher than Basel requirements, supervisors are using stress tests to introduce what amounts to new minimum regulatory requirements.[2]

Supervisors are also stepping up demands that banks improve the way they manage capital and liquidity, both on a business-as-usual basis and under stress. This starts with data: banks need to improve the accuracy, timeliness and extent of the data that they collect and on which they manage risk and base their reporting and disclosure. Banks also need to identify risks and vulnerabilities associated with the firm’s business model, as well as identify the conditions and develop scenarios that would stress those vulnerabilities. Banks then need to model how capital and liquidity might be impaired and integrate the results with their capital and liquidity planning. All this needs to be done on a legal-vehicle as well as group-wide consolidated basis. To accomplish this agenda, banks will need to improve their systems and controls as well as integrate finance and risk data and technology. Supervisors are likely to use stress testing as a means to ensure that banks are making progress on this front, particularly with respect to intra-day liquidity reporting and collateral management.

Although capital and liquidity can ensure financial resiliency, they cannot ensure business continuity or resiliency in operations. Banks’ ability to perform critical economic functions (such as making payments) depends on their ability to keep their systems running at all times. With respect to operational risk, mitigation – not modeling – has become the order of the day, with cyber as the number one threat. Supervisors will expect banks to have programs in place to hold this and other threats to operational continuity in check.

## Do you conduct yourself correctly?

Supervisors will be looking for the bank to demonstrate that it will act with integrity when it deals in financial markets and that it will treat customers fairly. To do so, banks will need to show not only that they are in compliance but also that they are in control. Banks need to build upon the general work that they are doing to improve culture and align incentives with effective risk management. The emphasis needs to shift from curing breaches to anticipating where risks may arise and then preventing them from occurring.

[2] See Huertas (2016, forthcoming), “Do stress tests pass the test?”

From the perspective of supervisors, banks' current compliance models need to be overhauled. These historical approaches failed to prevent market rigging, and they failed to protect customers. As banking moves further into the digital age, a new risk landscape being introduced by technology innovations, with ever-shrinking life cycles and delivery times, there is no way that a fully historical approach to compliance will keep up with modern demands. If maintained, the current compliance models could also compromise the bank's condition. Losses due to fines, settlements and restitution now exceed credit losses. And increasingly, regulators are looking to hold individuals, as well as institutions, to account for failure. Consequently, stress tests today routinely require banks to reserve capital now against the fines and settlements they are likely to incur over the next three to five years.

From the investors' perspective, initial earnings are not necessarily final earnings (net income after tax, fines and settlements). As a consequence, risk to investors is higher, and so is the cost of capital. It is likely to stay that way until banks demonstrably improve their conduct.

This suggests that an ounce of prevention may well be worth a pound of cure. This starts with strengthening governance overall (see next question). But it doesn't stop there. To avoid fines and settlements afterward, a bank needs to begin managing conduct risk even before it approaches the customer or impacts the markets. It needs to better anticipate where conduct risk may arise. In addition, it needs to make sure that products and services are appropriate for the customer, that the processes are not open to abuse or subterfuge and that the bank complies with applicable law and regulation. This goes not only for new products but existing ones as well. Indeed, the most significant conduct risks may lie in businesses that appear to be doing extraordinarily well.

The bank also needs to be sure that a fully compliant business is inherently structured to earn its cost of capital. If the business cannot, there is a danger that the business will take on conduct risks in order to meet the targets the bank has set. If breaches result, the bank may face crippling fines or penalties. Rather than expose itself to such risk, the bank may prefer not to engage in the business at all. This consideration is particularly relevant for businesses with high fixed costs of compliance with regulation, low margins on individual transactions and high penalties for getting a transaction wrong. Unless the bank has a large volume of transactions and an efficient, straight-through way to process them (and thereby ensure compliance), the bank should consider whether it still makes sense to stay in the business.

Cross-border remittances are a case in point. In recent years, concerns about terrorism and financial crime have led to a progressive strengthening of regulations obliging banks to know not only their own customer (KYC) but also their customer's customers (KYCC), to take anti-money laundering (AML) measures, to comply with sanctions, and to know the ultimate originator and beneficiary of any payment that the bank makes or receives. At the same time, penalties for breaches have risen and continue to rise. The bottom line accordingly reads: "billions (in fines), if you get it wrong; millions (in profits), if you get it right."

That's not necessarily a good trade-off. Banks with low volumes of business are electing to exit correspondent banking entirely. Those banks that remain in the business are becoming more selective about the correspondents with which they are willing to transact and more innovative in seeking ways to transact directly with the end beneficiary (so that the bank can control compliance from start to finish rather than rely on – and take responsibility for – its correspondent's compliance). Such steps can ensure that the bank will "get it right."

## Do you have the right governance?

Supervisors have also raised the bar on risk governance. As part of this, they will be looking for the bank to demonstrate that it can set – and keep – risk appetite at a sensible level. To do so, the bank will need to embed its risk appetite framework and risk appetite statement into daily business decisions, so that the managers on the line accept only the right risks and control them in the right way.[3]

[3] See GRN (2015), "An international regulatory push for enhanced risk governance."

How can this be done? The answer is straightforward. Use all three lines of defense, starting with the first, business line management. Make it responsible for the risks it assumes – credit, market, conduct, operational, etc. After all, it is the assumption of such risks that underlies the returns that the business generates. Use the second line to control the first, not do the job of the first. Risk management should approve limits, monitor adherence to those limits and deal with exceptions. They also need to ensure that the control structures keep risk within the defined risk appetite framework.

Compliance should review control processes to ensure that the bank is mitigating conduct risk, that the bank not only deals with breaches as they occur but draws lessons from the episodes to prevent such problems from recurring. Forward intrinsic conduct risk needs to be assessed, and in many banks, conduct risk is now being brought under the risk function. Banks will also need to demonstrate that they have fully independent control functions to oversee all risks, including conduct and legal.

Banks need to use the third line (internal audit) to make sure that the first two lines are working as they should. Compensation also needs to be aligned with effective risk management: if an executive fails to keep his/her business in line with controls, s/he should be out of a bonus and possibly out of a job. Finally, banks need to reinforce all three lines by increasing accountability of boards and senior executives, both collectively and as individuals. The net result should be a more efficient bank, one that has a better culture, one that is prone to fewer errors and one that can actually retain the earnings it initially reports.[4]

## Are you resolvable?

In the regulators' view, the policy pieces are falling into place to make banks resolvable. Revisions to law and regulation are creating effective resolution regimes so that banks can fail without significant adverse effects on financial markets or the economy at large and without cost to the taxpayer.

Bail-in and loss-absorbing capacity (LAC) are key attributes of these new regimes.[5] Bail-in subjects creditors to write-down and/or conversion (into common equity) at the point of non-viability (and the point at which the bank should enter resolution). LAC requirements ensure that the bank has enough "reserve capital" for bail-in to replenish the failed bank's capital.

During 2016, supervisors and/or resolution authorities will accordingly put increased pressure on banks to demonstrate that they are resolvable. To do so, banks will have to show not only that they can bail-in an appropriate amount of reserve capital but also that they can obtain adequate liquidity and can continue to perform critical economic functions while in resolution. Banks have to be able to demonstrate that they have the resources, the structure (i.e., a rationalized legal entity structure that is aligned with businesses) and the operational and financial modeling capabilities required to evaluate and execute a range of recovery actions and to support the entire resolution process. In short, the authorities will assess whether it is possible to put together what amounts to a pre-pack resolution scheme. If not, supervisors may order the bank to hold additional capital and/or make changes to the bank's structure.

Note that such changes to structure would accelerate and/or add to those already mandated under existing legislation and regulation, such as the prohibition on proprietary trading, the separation of trading activity from retail and commercial banking, the introduction of mandatory clearing for derivatives and the requirement that foreign banking organizations place their subsidiaries into an intermediate holding company.

[4] Note, however, that this result may well depend on how regulators formulate and supervisors implement the attestation requirements that are being introduced in connection with stress testing, compliance with sanctions and AML and governance generally. If the bank's failure to comply means jail and/or bankruptcy for the accountable executive, the bank may have difficulty recruiting and/or keeping executives who are fit and proper. Such a counterproductive result is particularly likely if the authorities can impose such punishment without having to prove that the executive acted negligently or in an unreasonable manner.

[5] See GRN (2016), "The FSB's TLAC standard: what banks should be doing in response."

Taken together, structural changes already in process point toward a new banking model. Regulators are pushing global banks away from the big, broad and borderless approach that they employed before the crisis, in which the bank's home country supervisor oversaw the group on a consolidated basis. Now each supervisor is primarily interested in its market, its businesses, its consumers and the legal vehicles authorized to operate in its jurisdiction. As a result, supervisors are pushing banks to become smaller, simpler and separable into distinct legal vehicles.[6]

## Implications for banks

The above questions have significant implications for banks. The first relates to the standards supervisors expect. Banks will increasingly need to demonstrate via rigorous testing that their governance, systems and controls work as they should. Data management is a case in point. Accurate and timely data is required to answer each of the questions outlined above. Without excellent data architecture and data management, there is a risk of "garbage-in and garbage-out." To offset this risk, supervisors are likely to impose extra capital buffers on banks whose data management is deficient.

The second is the importance of legal vehicles. Increasingly, banks will have to report and manage according to legal vehicles, as well as on the basis of global business lines and the group as a whole. Regulation requires banks to meet standards not only on a group-wide or consolidated basis, but at each legal vehicle within the group. This applies not only to capital and liquidity requirements, but also to governance arrangements. Indeed, in some cases, regulators require the board of the subsidiary to be "independent" from the group that owns it.

Investors are also likely to place increasing emphasis on legal vehicles. In a world where bail-in becomes the norm for resolution, it will matter greatly on which legal vehicle the investor has a claim and where that claim stands in the vehicle's creditor hierarchy. Consequently, investors, counterparties and creditors (such as uninsured depositors) are likely to want improved disclosure from the legal vehicle on which they have a claim.

The third is to place the above questions in context. There is much talk about the need to assess the consequences of the massive regulatory reform program undertaken in response to the global financial crisis. To what extent have these reforms led to a contraction in services (e.g., correspondent banking, cross-border remittances) or to a reduction in liquidity (e.g., in corporate bonds)? To what extent has stricter regulation of banks merely shifted activity into the shadows, to non-banks such as hedge funds? To what extent has the reform program made the financial system more stable? These are but some of the many issues that a comprehensive review of the reform program could consider. But such a review will not be completed in 2016. Neither is it likely that regulators will reverse any of the reforms in 2016. Nor is it likely that jurisdictions will harmonize the way in which they implement the reforms. Each will do it in its own way, and banks will have to comply with local regulation in each of the jurisdictions in which they do business. In practical terms, this may imply that the banks will need to meet on a global basis the highest standards set by any one major jurisdiction.

Finally, banks need to bear in mind that satisfactory answers to supervisory questions ultimately depend on business models. Banks must be able to satisfy customer demands in a sustainably profitable manner even in a still-fragile economic environment, even in the face of rapid technological change and even under the pressure of increasing competition. That demands discretion with respect to strategy (i.e., choosing to compete where the bank can win) and discipline with respect to execution (determining and doing what it takes to win). Supervisors can limit the range of choices that a bank may make, but they cannot make the choice. That is and remains the responsibility of the bank's management and board.

[6] See the *Financial Times* (January 2016), "Regulating from within: The Banker special report 2016." See also for similar discussions on stress testing, governance and culture.

For additional information


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Marie-Hélène Fortésa: Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority); Association Française des Banques (French Banking Association); and French National Institute for Statistics and Economic Studies. She has also held senior roles at a global investment bank

Dr. Tom Huertas: UK Financial Services Authority's Executive Committee; Alternate Chair of the European Banking Authority, Basel Committee on Banking Supervision; and Financial Stability Board Resolution Steering Committee

Patricia Jackson: Basel Committee Member; Basel II lead; Global Quantitative Impact Studies Committee Chair; Basel II Calibration Subgroup chair; Head of the Financial Industry and Regulation Division of the Bank of England

Hidekatsu Koishihara: Chief inspector and inspection administrator for the Japan Financial Services Agency, Ministry of Finance (MOF) of Japan; Japan's former financial regulator as financial inspector at the Bank Bureau of MOF and Financial Inspection Division; and Minister's Secretariat of MOF

John Liver: Divisional Compliance Lead at Barclays; Head of Department, Investment Firm Supervision, and prior roles in enforcement and supervision of investment management, life insurance and pensions at the UK Financial Services Authority and its predecessors. Current EY/UK Financial Conduct Authority relationship lead

Keith Pogson: Immediate Past President of the Hong Kong Institute of Certified Public Accountants; more than 20 years of experience advising governments and regulators across Asia-Pacific on acquisitions, market entry strategy and due diligence across banking, asset management and securities

Ted Price: Deputy Superintendent and Head of Supervision at the Office of the Superintendent of Financial Institutions, Canada, serving on the Senior Supervisors' Group and the Financial Stability Board Supervisory Intensity and Effectiveness Working Group. Prior to OSFI, Ted held senior roles at a global investment bank

Philip Rodd has more than 23 years of experience in accounting and risk management, including 13 years in the Asia-Pacific region. His areas of expertise include assisting clients in assessing the impact of regulatory change, implementing compliance initiatives and responding to regulatory findings

Marc Saidenberg: Senior Vice President and Director of Supervisory Policy at Federal Reserve Bank of New York; Basel Committee Member and Liquidity Working Group Co-chair; involved in the development of supervisory expectations for capital planning, liquidity risk management and resolution planning

David Scott is involved in addressing emerging regulatory and legislative initiatives and engaging in dialogue with regulators and supervisors on emerging issues. He has worked with a number of large global institutions, most recently on the implementation of the global financial regulatory reform agenda

Rick Small: Deputy Assistant Director, Federal Reserve System, Enforcement and Investigations, and Policy Leader for anti-money laundering and sanctions; executive leadership positions overseeing global financial crimes risk and compliance functions at American Express, Citigroup and GE Money; former federal prosecutor

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Scott Waterhouse was capital markets lead expert for large banks at the Office of the Comptroller of the Currency (OCC) and Examiner-in-Charge of the OCC's London Office. He coordinated the supervision of trading, treasury and capital markets activities including Dodd-Frank implementation and Basel Committee requirements

Shane O'Neill has 20 years' experience in banking, capital markets, asset finance and prudential regulation in CFO, COO, strategy and regulatory roles. As Head of Banking Supervision at the Central Bank of Ireland he influenced restructuring and recapitalization and executed numerous stress tests and asset quality reviews

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