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Executive summary

*Shifting focus: Risk culture at the forefront of banking* is the fifth annual study of risk management practices conducted by EY in cooperation with the Institute of International Finance (IIF) since the global financial crisis. A total of 52 firms across 27 countries participated in this year’s study. In July 2008, the IIF published the final report of the Committee on Market Best Practices, which set out principles of conduct and best practice recommendations for banks in light of the financial crisis. EY was asked, in 2009, to conduct a series of surveys of banking executives to assess the changes being made to risk management across the industry. The five surveys to date deliver a clear picture of the industry moving steadily year by year to enhance risk governance, taking on board the lessons from the crisis. The latest survey also shows that more work is still needed across a range of areas.

The new message this year is the almost universal focus on risk culture, with the emphasis on conduct, reflecting the range of global scandals that have come to light, including the fixing of a number of market benchmarks, such as LIBOR, and mis-selling cases in several countries. This has shaken boards’ certainty that they know the prevailing culture across a whole firm and has raised fundamental concerns about the quality of business-line controls and risk accountability. It has also led to new thinking about operational risk and, in particular, conduct risk.

Many of the other messages are similar to last year’s – banks are still trying to embed risk appetite, improve stress testing and enhance data and systems. These are still challenges, particularly against the backdrop of continuing pressures on business models from the implementation of Basel III, with investors unhappy about the lower returns on equity (ROEs), pushing for more yield and lower costs.

The financial industry has come a long way since the crisis, but the journey will continue for some time. Five key changes emerged in this year’s study.

**Sharper focus on culture and conduct**

The global industry is trying to tackle the question of risk culture: some firms are focused on assessing whether they have any reason to be concerned about the culture across the business, but many have moved into the phase of correcting or reinforcing the culture. One of the key issues highlighted is the need to shift accountability for risk into the front office. Another is the need for clear messages about risk from top to bottom in the organization, reinforced by training and performance metrics and held together by an embedded risk appetite. It is evident that this has to be linked with remuneration. With regard to enforcing accountability for risk, one executive remarked that it must affect individuals “where it counts – in their wallets.”
Shifting focus: Risk culture at the forefront of banking

Risk governance structures being strengthened

One important aspect of enhancing risk culture is risk governance frameworks. Boards and senior management are facing increasing scrutiny and pressure from regulators, the media and the public to tighten internal controls and reduce high-risk behavior. Rising litigation costs, steep fines and reputational damage have clearly been a catalyst for firms to re-evaluate and strengthen risk governance frameworks. Firms are adding new board-level committees to more closely monitor business ethics and conduct, and many are restructuring internally – streamlining and integrating current management committees, adding new committees and functions – to break down silos and close the gaps in risk oversight and control. Many are strengthening their three lines of defense to clarify roles and responsibilities, redesigning frameworks to shift risk accountability to the front line. The role of the risk function continues to expand, with some banks now ensuring it is involved with compliance risks, for example.

Greater attention to non-financial risk

Many banks thought the events that led to the large operational losses sustained during the past five years (fines, payments to purchasers of products, fraud losses and so forth) were the result of weak oversight and control processes. This has triggered risk and control reviews in a number of banks and spurred changes to accountability to ensure the front office focuses on the quality of the controls in the end-to-end activity. Banks have also increased evaluation of near-miss events and have sought mechanisms to improve information channels up through the organization, including whistle-blower arrangements.

Many reported special initiatives aimed specifically at strengthening processes around new products to reduce the likelihood of mis-selling risk. These include the use of senior- or board-level committees to review suitability and make certain that customers are being treated fairly.

Banks continue to struggle to embed risk appetite across the enterprise

Achieving a fully embedded risk appetite framework continues to be a significant challenge for many banks. Despite the fact that risk appetite has been a key area of focus for both boards and chief risk officers (CROs) in recent years, many firms are still finding it difficult to translate the firmwide risk appetite strategy into the day-to-day planning and operations of the business. While close to one-third of this year’s respondents say they have successfully integrated risk appetite into the business units (a steady increase over the past three years), more than one-half report continuing difficulty in moving the risk appetite approach further into their businesses. The impetus to integrate it further comes from the link seen to risk culture and ongoing pressure from regulators who view risk appetite as a brake on risk-taking and want it extended to include non-financial risks. As one interviewee told us, “Risk culture, risk appetite, business strategies, people and processes must all be aligned in order for everything to work effectively.”

Basel III regulations still driving fundamental changes to the industry

The industry is facing continuing pressures on business models from regulatory changes, particularly Basel III. The core issue is that with the higher capital and liquidity buffers, and with investors pushing back against the resulting lower ROEs, many business lines are now no longer sufficiently profitable. Many banks have exited entire lines of business and are still exiting countries and retreating to core markets. Prices for banking products are also being changed, but international banks are coming under competitive pressure from local banks in some markets and shadow banks in others. A key question is at what point the investors will accept the lower ROEs. Many believe that it will likely take some time because, as one executive summed up, “Investors want to see a track record and a pattern and until that starts to play out, there will be uncertainty about the long-term economic and return model under Basel III.”
Overview of 2014 study findings

Risk culture

Sixty-six percent are making changes to their culture, and 91% say that cultural change is still very much a work in progress. Only 38% say that individual behavior is significantly reflected in career progression, and only 30% believe it is fully understood that negative behavior will be penalized despite earnings performance. However, 86% report that severe breaches to the firm’s risk policies do result in disciplinary actions. Fifty-six percent say that achieving balance between front-office behavior and risk culture is their top challenge.

Driven by continuing high-profile conduct failings and growing pressure from regulators to tighten controls on risk behavior, there is an industry-wide effort to more effectively manage risk culture. Firms are approaching this from at least three directions: further strengthening risk governance and, in particular, shifting accountability for risk into the front office and ensuring the front office controls are in place and effective; clarifying the range of acceptable risk using an embedded risk appetite statement and various forms of messaging and training; and further aligning incentives with the objectives and clarifying how breaches in rules will be viewed.

Risk appetite

Only 31% say they have successfully integrated risk appetite into the businesses (a slow but steady increase over previous years). Sixty-three percent report a significant linkage of risk appetite into business planning, but only 35% say the day-to-day decisions are “largely tested” against risk appetite. Fifty-six percent report strong progress in their ability to track and enforce risk appetite.

Despite the fact that risk appetite has been a top area of focus for both boards and CROs over the past several years, many firms are still finding it difficult to translate the firmwide risk appetite into the day-to-day business decisions. While there is a strong regulatory push behind the strengthening of risk appetite frameworks, firms are also seeing real benefits in using the process to provide a unified view of risk as well as mechanisms against which individual decisions can be tested. The industry is reaching consensus in terms of the top-of-the-house metrics for setting and monitoring risk appetite, with 76% using some form of forward extreme loss metric. The next stage will be setting risk appetite for non-financial risk types, which is already starting.
Shifting focus: Risk culture at the forefront of banking

Forty-two percent say that board focus on risk remains high post-crisis. Risk appetite (80%), followed by risk compliance (68%), liquidity (66%) and regulatory risk (66%) are top areas of focus for the board. Credit risk (59%), risk appetite (56%), operational risk (50%) and regulatory compliance (50%) are listed as top areas of attention for the CRO. Fifty-seven percent report increases in the size of the risk function over the past 12 months, and 53% expect increases to continue next year.

The exposure of conduct failings in many banks is influencing the structure of risk governance right up to the board level. Banks are adding new committees at both board and management levels to monitor conduct and ethics, and some firms are shifting responsibility for compliance to the CRO and risk function. Banks are streamlining governance structures to break down silos and close the gaps in risk oversight and control and are strengthening their three lines of defense models to further clarify the division of responsibility and accountability. To better adapt to regulatory requirements, firms have made changes to their boards to increase areas of expertise – mainly in regulation and banking. Many are concerned that continuing pressure from regulators to increase the role of the board is blurring the line between board and management responsibilities, and many worry that the day-to-day demands on boards are unrealistic. The role of the CRO continues to expand in focus and responsibility in most firms.

Operational risk

Ninety-two percent report increased board and senior management attention on operational risk, while 76% cite weak oversight and controls as main causes of loss events. Seventy-nine percent say the front office and business heads are responsible for day-to-day management of risks. Improving scenarios (41%) and modeling (35%); increasing focus on new products (48%) and new customers (37%); and strengthening business-line compliance functions (59%) are among key areas of focus. Nonetheless, many banks believe that the tools and clarity around the accountabilities are not sufficient to make this front-office responsibility real.

Operational risk, which has been a catch-all category for many types of risk, is moving toward more granular assessment of individual risks. The majority admit that weak oversight and controls have been the primary factors contributing to loss events that many have suffered. As a result, most banks are enhancing operational controls and processes to identify control weaknesses. Firms are increasingly focusing on forward-looking risk assessments and prevention versus after-the-fact analysis of a risk failure, and many are enhancing scenario and modeling processes to better assess forward risk. In the conduct area, a host of initiatives were identified, including increased attention to new product development and the fair treatment of customers. Important changes in governance and accountability included strengthening group compliance functions and making business units fully responsible for operational risk.
Stress testing

Seventy-one percent have created new stress testing methodologies in the past 12 months. Top areas where stress testing is used include capital planning (96%), risk management (90%) and risk appetite management (79%). Seventy-three percent have increased collaboration with business units, and 69% have increased the variety of scenarios. Fifty percent take two months or more to complete a group-wide test.

Banks are continuing to improve and refine stress testing methodologies. Many are moving toward a more holistic firmwide stress testing framework to improve consistency and comprehensiveness in measurement across risk types. Firms are trying to move to a position where they can use stress testing as a management tool and are beginning to link stress testing to financial planning to access balance sheet and P&L outcomes in stress environments. However, the slow turnaround of results and lack of standardization are a barrier to using the output, and there is still some way to go to link stress testing to strategic and business decisions. Central departments are being set up to focus on stress testing, but many complain about the sheer amount of time and resources devoted to the supervisory-led stress tests in some countries.

Liquidity management

Eighty-three percent say asset-liability committees (ALCOs) are responsible for liquidity risk; however, 42% list the risk committee as responsible, and a growing number, 10%, say balance sheet committees are involved. Sixty-six percent manage liquidity at both the group and legal entity level. Fifty percent have made changes to counterparty/customer charges, and 52% have introduced new approaches to funds transfer pricing.

Firms are making ongoing investments in people and technology to deal with the complex liquidity regulations under the Basel regime. While ALCOs continue to be primarily responsible for managing and monitoring risk, there is a growing trend toward more holistic management of liquidity, and many institutions are spreading responsibility across a number of areas, including risk, finance and balance sheet committees. A wish to diversify funding sources along with regulatory pressure are driving an ongoing shift from managing liquidity at the group level to a more layered approach that includes both group and local entity levels. In an effort to more accurately reflect liquidity costs, over half have made changes externally to customer and counterparty charges and internally to business unit funds transfer pricing.

Capital management

Sixty-seven percent have changed approaches to capital management, and 62% say aligning economic capital with regulatory requirements is the main driver of change. Eighty-three percent manage capital across legal entities and geographies.

More than two-thirds of firms have made changes to their approach to capital management in the past 12 months. Aligning capital allocation with the higher regulatory capital requirements is the main driver for these changes. Another focus is streamlining legal entity structures to reduce trapped liquidity and capital in local entities.
Shifting focus: Risk culture at the forefront of banking

Impact of Basel III

Changes to business models include exiting lines of business (43%) and countries (11%); streamlining legal entities (38%); and shifting out of less liquid instruments (28%). Eighty-three percent continue to evaluate portfolios and 26% anticipate the effect of higher costs of margins on unsecured corporate loans to be 50 or more basis points. Sixty-five percent say Basel III will have a significant impact on costs, and 52% target lower ROEs of between 10% and 15%. Since the start of the financial crisis, 82% of banks have reduced their targeted ROE, while 52% have reduced target ROEs further in the last year. Seventy-two percent say investors are pushing for increases in ROE.

Recovery and resolution planning

Seventy-seven percent have completed recovery plans while only 30% say they have completed resolution plans. Both recovery (72%) and resolution (86%) plans took up to a year for completion. Seventy-one percent report no changes as a result of the recovery and resolution planning (RRP) process.

Internal transparency, data and systems

Eighty-five percent cite data and 83% cite systems as top challenges. Forty percent say they have a documented inventory of risk data, but less than 20% are confident they have robust data metrics to identify risks, and only 6% say they can provide comprehensive firmwide risk reports. Seventy-five percent report an increase in IT spend in the past year while 65% anticipate costs will continue to rise.

Data and outdated systems remain the top challenges to complying with Basel III regulations and achieving enhancements in stress testing and risk transparency. Improving data aggregation to meet new requirements, streamlining reporting to improve transparency and upgrading systems are key initiatives underway in many firms. Most banks have made significant investments in IT upgrades since the crisis, and many believe there is no abatement in sight.
Research methodology and demographics

From January 2014 through April 2014, in cooperation with the IIF, EY surveyed IIF member firms using two methods. An online quantitative survey was distributed to the top (by asset size) member firms and the team conducted telephone interviews with CROs and other senior risk executives of many of the largest global firms. A total of 52 firms across 27 countries participated in the study either online, by telephone or both.
<table>
<thead>
<tr>
<th>Africa/Middle East</th>
<th>Asia-Pacific*</th>
<th>Europe</th>
<th>Latin America</th>
<th>North America</th>
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<td>Commerzbank AG</td>
<td>Itaú Unibanco</td>
<td>CIBC</td>
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<td>Credit Suisse</td>
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<td>Siam Commercial Bank</td>
<td>Nordea Bank</td>
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<td></td>
<td>Sumitomo Mitsui Banking Corporation</td>
<td>SEB</td>
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<td>Suncorp Group</td>
<td>Société Générale</td>
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<td>Standard Chartered Bank</td>
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<tr>
<td></td>
<td></td>
<td>UBS</td>
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* One bank in this region asked to remain anonymous.
Risk culture

Many initiatives underway to more effectively manage and monitor risk behavior

“In the past, bad managers who bullied the risk team and their own people were tolerated because they made a lot of money. That is absolutely not the case anymore. It’s a very strong message to be told that your pay is being cut by X percent because of your behavior. It’s pretty incredible to see the change in our organization.”

Risk culture and its impact on effective risk management have clearly become a top-of-mind issue for boards and senior management. The financial industry has been shocked by the high-profile conduct failings that have come to light since the crisis in areas such as LIBOR and product mis-selling, and regulators have stepped up their pressure on firms to tighten controls on risk behavior. As a result, there has been an intensified industry-wide effort to review, assess and make changes to more effectively manage risk culture. In the past two years, more than half of study participants (52% this year and 57% last year) reported increased attention to risk culture on the part of senior management (see Exhibit 1).

What is striking is the extent of the changes being made by firms around the world. The majority of participants across all regions indicate they are in the process of changing the culture in their organizations (see Exhibit 2), and almost all (91%) say that these changes are still very much a “work in progress.” As is evident throughout this chapter, these changes are being made on a wide variety of fronts. For some firms, these efforts represent, as one executive told us, “more of a natural

**Exhibit 1:** Senior managers continue to report an increased focus on risk culture

- There has been an increase in attention in the past 12 months: 52% (2014) vs. 57% (2013)
- Risk culture has been an area of increased focus since the 2008 crisis: 26% (2014) vs. 39% (2013)
Shifting focus: Risk culture at the forefront of banking

with risk appetite as a central driver. This is consistent with the messages from the Financial Stability Board (FSB) in its April 2014 paper, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture*, which lists embedding the risk appetite into the businesses as one of the foundational elements for a sound risk culture (risk appetite is covered further in “Risk appetite” on page 19 of this report). But it is clear that change is not driven purely by regulatory pressures. Over one-third (36%) of respondents report that board concerns are driving these initiatives and, for many firms, strengthening the culture is part of an effort to rebuild their reputation in the industry and restore customer trust.

Executives agree that institutionalizing a strong risk culture that creates a tangible sense of risk ownership from the top ranks of the organization down to the front-line staff requires fundamental changes. These changes must be driven from the top of the firm and require a significant amount of time and commitment on the part of the board, CEO, CRO and the entire senior management team. Key ingredients for success must include a strong risk appetite that is embedded into business strategy and planning; clearly defined roles, responsibilities and accountability; risk transparency; and strong consequences for misbehavior through performance management, compensation and disciplinary actions. For many firms, making risk everyone’s business represents a significant shift in mindset, policies, systems and processes and requires an ongoing, long-term commitment and investment.

**Key activities to strengthen the risk culture**

While there are a few executives who continue to believe that culture is elusive and difficult to define and measure, there was a clear shift in our discussions this year to general agreement that culture can be deliberately changed and effectively managed, monitored and enforced with formal programs and processes that have been tested and proven across many industries. As one executive explained, “Some people think

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**Exhibit 2: The majority of firms are in the process of changing culture**

<table>
<thead>
<tr>
<th>Region</th>
<th>Yes (%)</th>
<th>No (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>66%</td>
<td>34%</td>
</tr>
<tr>
<td>Africa/Middle East</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>62%</td>
<td>38%</td>
</tr>
<tr>
<td>Europe</td>
<td>69%</td>
<td>31%</td>
</tr>
<tr>
<td>Latin America</td>
<td>75%</td>
<td>25%</td>
</tr>
<tr>
<td>North America</td>
<td>75%</td>
<td>25%</td>
</tr>
</tbody>
</table>

**Yes**

**No**

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evolution and maturity versus an active intervention,” while for others, the changes are part of enterprise-wide transformation initiatives.

As can be seen in Exhibit 3, firms cite a broad range of drivers behind culture change. One goal of nearly three-quarters of firms surveyed (73%) is delivering consistency across organizational culture, employee behavior, risk appetite and risk culture. A further 61% see alignment of risk culture with risk appetite as a central driver. This is consistent with the messages from the Financial Stability Board (FSB) in its April 2014 paper, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture*, which lists embedding the risk appetite into the businesses as one of the foundational elements for a sound risk culture (risk appetite is covered further in “Risk appetite” on page 19 of this report). But it is clear that change is not driven purely by regulatory pressures. Over one-third (36%) of respondents report that board concerns are driving these initiatives and, for many firms, strengthening the culture is part of an effort to rebuild their reputation in the industry and restore customer trust.

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of culture as a soft thing, but I see it as a very hard strategic asset.” While specific initiatives varied, opinions on sound practices coalesced around several critical activities:

- Start at the top with a well-articulated culture statement, policies and procedures
- Embed risk thinking through risk appetite
- Continuously reinforce and instill the culture through communications and training
- Clearly define roles, responsibilities and expectations
- Reinforce accountability through performance reviews and compensation
- Constantly assess and monitor progress

### Defining the risk culture starts at the top of the organization

Executives agree that commitment to cultural change must start at the top of the organization. The board and senior management must commit the time and resources to agree on the firmwide values and culture. One of the key themes is creating a unified message that ties together the “rules of the road” of what constitutes acceptable risk behavior with the firm’s overall vision, values and culture, which define how the firm wants to do business and how it wants to be perceived by key stakeholders — customers, employees, shareholders and regulators. Many believe that at a fundamental level, risk culture is ultimately about the business model the firm chooses to follow and the way business is conducted on a day-to-day basis. As one executive summed up, “It’s all about doing the right business the right way.”

As we discuss more fully in “Risk governance” on page 29, many firms are making significant changes at both the board and internal management levels to more closely monitor and control conduct risks throughout their organizations. Many have created new board and management committees to focus on business ethics and establish firmwide codes of conduct policies and procedures. Several executives discussed their very detailed code of conduct manuals, which explain what one executive called “all the many dos and don’ts of expectations.” One executive described a new process in which everyone in the organization is required to spend 60 minutes reviewing an online conduct training manual before signing the code of conduct statement. According to the interviewee, “This is definitely not just one of those ‘going through the motions’ training sessions where you can just click the button and accept the terms. The time is monitored, and if you walk away, you have to start all over again. The firm is trying to tell everyone that this is very important.”

Consistency and alignment of messages are another important theme, and several executives interviewed believe there is confusion around the multitude of “statements” within their organizations. As one executive told us, “We have a values statement that is overarching and sets culture; then we have a code of conduct and ethics, and then we have a risk appetite statement. And more recently, there have been various statements from individual businesses as to how they want to do business. Ultimately, these all need to be rolled up into one
firmwide message that sums up the right way to do business in our organization.” And from another executive, “We have a very strong and established firmwide vision, values, culture and code of conduct. I am concerned about saying we have a ‘risk culture’ because people are going to be confused as to whether we now have two separate cultures or if this is part of the same culture that we have always had. I think the regulators and the industry should settle on the term ‘risk conduct’ because it is much less confusing internally.”

Embed risk thinking through risk appetite

The message is loud and clear from executives interviewed that embedding a strong and pervasive “risk view” — in which everyone throughout the firm is responsible for risk — is crucial to establishing a successful risk culture. Many believe a well-articulated risk appetite framework that is effectively cascaded throughout all strategy and business planning, risk policies and procedures, and performance and compensation decisions is the best expression of risk culture. As one executive explained, “Getting a risk appetite framework in place throughout the firm is a key element of bringing the risk culture to life and making it ‘real’ throughout the organization.” As we discuss more fully in Chapter 2 on risk appetite, concerns about excessive risk-taking pre-crisis have led many banks to formalize and standardize their risk appetite frameworks, and many are working to articulate and communicate more clearly the risk process that everyone must follow. As one executive told us, “We now have one master document all businesses can understand that discusses all of the many different risk types that need to be watched and reviewed and outlines the standard risk processes that everyone should be applying. It’s pretty clear now who should be doing what and when.”

The amount of time and degree of effort that the board and senior management devote to the development and execution of the risk appetite framework is a critical aspect of risk culture. And several say it is extremely important for the CEO to visibly support the process and act as the final arbiter of risk deliberations.

Continuously reinforce the culture

Seventy-four percent of respondents report they are enhancing communications and training programs to raise awareness of risk values and expectations (see Exhibit 4). Many agree that effectively instilling risk culture is a constant and repetitive process involving a variety of channels, tools, policies and procedures. The process should begin with a rigorous recruiting effort to bring on board the right people who are the best match — both culturally and technically — with the organization. From there, the culture must be reaffirmed formally and informally through new-staff orientations, ongoing training programs, regular town hall meetings and events, CEO communiques, written materials and manuals, and in general, prolific communications at all levels. One executive described a huge firmwide initiative to embed a new set of values throughout the organization. It included a host of activities, from holding extensive meetings and courses to placing large murals listing the firm's values in all the reception areas and meeting rooms around the world. Training was repeatedly mentioned as one of the most effective tools for raising awareness and understanding of risk culture, and several interviewees discussed new training initiatives in their organizations. One executive, for example, described the development of a new risk academy with courses on many types of risk that is open to all employees, from the risk areas to front-line staff.

Exhibit 4: Top initiatives to strengthen risk culture

<table>
<thead>
<tr>
<th>Initiative</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enhancing communication and training regarding risk values and expectations</td>
<td>74%</td>
</tr>
<tr>
<td>Strengthening risk roles and responsibilities</td>
<td>72%</td>
</tr>
<tr>
<td>Reinforcing accountability regarding risk management</td>
<td>68%</td>
</tr>
<tr>
<td>Aligning compensation with risk-adjusted performance metrics</td>
<td>58%</td>
</tr>
<tr>
<td>Changing treatment of control breaches</td>
<td>36%</td>
</tr>
<tr>
<td>Changing policies and procedures</td>
<td>34%</td>
</tr>
<tr>
<td>Developing new ethics codes/committees</td>
<td>30%</td>
</tr>
<tr>
<td>Changing compensation to reflect softer cultural issues</td>
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</tr>
</tbody>
</table>
Clearly define roles, responsibilities and expectations

Executives agree that well-defined and clearly articulated risk ownership roles and responsibilities are a critical component of effective risk governance. Seventy-two percent of survey participants indicated they are strengthening roles and responsibilities in their organizations (see Exhibit 4). In their post-crisis assessments, many firms found confusion around risk oversight expectations and gaps in risk processes and responsibilities throughout their organizations. As a result, many have made, and continue to make, adjustments to their governance models to strengthen and clarify responsibilities. As can be seen, 68% of respondents listed reinforcing accountability as a key to strengthening the risk culture.

One CRO explained, “It is vital that everyone understand their accountability for managing, monitoring and escalating concerns, if necessary, in their daily activities.”

As can be seen in Exhibit 5, aligning the sales-driven front-office culture with the broader firmwide risk culture is cited by the majority of respondents as the top challenge to strengthening the risk culture. This has led to initiatives to define the roles, responsibilities and accountability of the front office more clearly. For most firms, the front office has traditionally focused on revenue targets and the risk responsibilities have been confined to not breaching limits. The problem is that, typically, the limits set for the front office did not address many of the risks now in the spotlight, such as conduct and compliance. But this is changing, and firms are

---

Exhibit 5: Top challenges to strengthening the risk culture

- Achieving balance between sales-driven front-office culture and risk-focused culture: 56%
- Messages not cascading effectively throughout the organization: 54%
- Business taking ownership of risk: 36%
- Systems and data: 32%
- Enforcing accountability: 30%
- Establishing a proactive risk culture: 26%
- Aligning incentives: 20%
- Competitive pressures: 18%
- Allocation of risk appetite including wider risks: 18%

Exhibit 6: Extent to which individual behavior is reflected in career progression and compensation

Exhibit 7: Is it understood throughout the organization that negative behavior is penalized and positive behavior rewarded despite earnings performance?
launched active programs to realign the responsibilities for their three lines of defense, with the front office now taking responsibility for all risks, including conduct.

**Reinforce accountability through performance reviews and compensation**

To reinforce accountability, there is continuing work on aligning compensation with performance metrics. This is clearly evident in Exhibit 4. But there is still some way to go to capture wider areas of culture in compensation. Only 26% are including “softer,” more qualitative cultural behaviors in their compensation calculations.

In addition, only slightly more than one-third of participants (38%) say that individual behavior is reflected in career progression and compensation “to a significant extent” in their organizations although 52% indicate that behavior is reflected “to some extent.” Nonetheless, some link to behavior is becoming almost universal, with only 6% saying that behavior is not reflected at all in career and compensation decisions (see Exhibit 6).

The ongoing journey to embed the message of accountability is also highlighted by the fact that only 30% of respondents believe it is “completely understood” throughout their organizations that negative behavior is penalized and positive behavior rewarded. And more than two-thirds of firms (68%) believe that the level of understanding of the message continues to vary by department and location (see Exhibit 7).

However, progress is clearly being made. Several executives described rigorous review processes to monitor performance. One firm has developed an assessment template that incorporates adherence to each of the firm’s 10 values into the annual appraisal process used to evaluate every employee throughout the firm. As the executive explained, “Everybody everywhere around the world is assessed in the same way. It’s completely embedded in our organization; it reinforces our values and culture, and it is an important part of the glue that holds us together.” Other firms had similar approaches. Some are increasing the intensity of the performance process for individuals who could negatively impact the organization if they acted in an inappropriate way. In one firm, the people who fall into these high-risk categories are subject to a deferred compensation structure and undergo a substantial amount of additional scrutiny. “Every single person in this high-risk category is reviewed by every single control function against a set of behavior statements, and if they are flagged, there’s a real escalation process, and it will impact their performance review. And if it’s bad enough, they will be subject to big clawbacks.”

Firms are also trying to introduce automaticity into the performance evaluation process. One firm closely tracks the number of limit breaches for each trader per year, and any trader with more than three or four breaches will be flagged in his or her performance review and compensation will be impacted. According to the executive interviewed, “We all set our limits tight enough that we expect to have the occasional breach because the markets shifted unexpectedly. But anyone with multiple breaches is not taking the limits seriously enough to check before they do a trade, and we consider that to be both a risk appetite and a risk culture violation.”

Many executives described more in-depth review procedures to assess the nature and degree of individual breaches and much tougher disciplinary actions for employees who have knowingly committed a breach. One interviewee said, “We are very meticulous about making sure that any conscious behavior in defiance of the rules, even by people who bring in a lot of money, is severely sanctioned.”

More than one-third (36%) of participants reported they are changing the way they treat control breaches in their organizations (see Exhibit 4), and 86% indicated that

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**Exhibit 8: Actions taken if an individual breaches controls**

<table>
<thead>
<tr>
<th>Action</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>A severe breach would result in disciplinary action</td>
<td>86%</td>
</tr>
<tr>
<td>The risk control department is immediately notified</td>
<td>76%</td>
</tr>
<tr>
<td>It is dealt with by the desk heads/business line head</td>
<td>60%</td>
</tr>
<tr>
<td>The breach is always considered in career progression/compensation decisions</td>
<td>42%</td>
</tr>
<tr>
<td>The disciplinary procedures are clearly defined against levels of breach and are incorporated in career management</td>
<td>36%</td>
</tr>
<tr>
<td>The breach will always affect career progression/compensation</td>
<td>16%</td>
</tr>
</tbody>
</table>
a severe breach would trigger disciplinary actions (see Exhibit 8). Breaches are dealt with at different levels within the organization. For 76% of respondents, breaches are immediately escalated to the risk control functions.

Nonetheless, this is still a work in progress. Only 36% of banks said that disciplinary procedures are clearly defined against levels of breach and are incorporated into career management. And 60% continue to deal with breaches in controls at the desk and business-line level; 24% of them do not notify the risk control department.

### Constantly review, assess and monitor progress

There are still mixed opinions on how to effectively monitor and measure risk culture throughout the organization, and executives agree they have a way to go to formalize their assessment processes. Less than half (49%) of respondents say their firms have an agreed framework by which risk culture is regularly assessed, perhaps because this is an evolving process, and 51% say they do not have a framework in place.

While 64% of participants indicate that risk culture is explicitly assessed in the business units either by internal audit, the risk organization or by both groups, more than one-third (36%) say that neither group conducts a formal risk culture assessment of the businesses (see Exhibit 9).

**Exhibit 9:** Do the risk organization and internal audit explicitly assess culture in the business units?
Shifting focus: Risk culture at the forefront of banking

Firms that are monitoring the risk culture are typically using a combination of quantitative and qualitative metrics or, as one executive explained, “For us, measuring culture is a bit of a triangulation of three or four different sources of information — some quantitative, some qualitative and some based on the judgment of our senior management.” Exhibit 10 illustrates some of the key monitoring tools that firms are adopting to measure the risk culture. Assessing the frequency, scale and causes of breaches to risk limits and how they are reported and handled are all listed as primary measurements. Sixty-one percent review the issues identified in internal audit reports, including the manner in which they are handled and the pre-existing awareness of the problems, to determine if management was surprised by the findings or already addressing the issue.

On the more qualitative side, over half (52%) of participants indicate they are incorporating periodic reviews and annual employee surveys into their assessment processes. Several discussed specific assessments of the risk culture conducted firmwide by third parties to identify gaps in the culture and establish benchmarks to measure against going forward. Many executives agree that the frequency of surveys is critical to measuring progress, and many of our interviewees say they have incorporated risk culture-specific questions into their annual employee surveys. In addition, several have developed risk culture dashboard reports to track progress across key culture attributes and indicators.

Thirty percent of respondents track the frequency and treatment of both self-reported control and risk problems as well as whistle-blowing incidents. Openness to challenge is regarded as an important attribute of risk culture; however, several discussed the challenges of creating a balance between strengthening accountability and creating a culture of fear. As one interviewee explained, “It’s a delicate balancing act because you do want people to be accountable for their actions, but if you play that in a wrong way, you’ll drive people underground, which creates the wrong culture.”

Exhibit 10: Banks are monitoring adoption of new culture through a variety of methods

<table>
<thead>
<tr>
<th>Activity</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reviews of action taken when controls are breached</td>
<td>79%</td>
</tr>
<tr>
<td>Issues raised via internal audit reports</td>
<td>61%</td>
</tr>
<tr>
<td>Reviews and surveys</td>
<td>52%</td>
</tr>
<tr>
<td>Breach of rules leading to disciplinary proceedings</td>
<td>48%</td>
</tr>
<tr>
<td>Scale of breach of risk limits</td>
<td>48%</td>
</tr>
<tr>
<td>Frequency that risk limits broken</td>
<td>45%</td>
</tr>
<tr>
<td>Internal whistle-blowers</td>
<td>30%</td>
</tr>
</tbody>
</table>
## Examples of risk culture indicators

<table>
<thead>
<tr>
<th>Mechanism (tools)</th>
<th>Risk culture attributes (outcomes)</th>
<th>Examples of risk culture indicators (behavioral statements)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Strong leadership and values are aligned with behaviors</strong></td>
<td>Clear tone from the top and consistency with middle management approaches</td>
<td>• Senior leaders and the board can unanimously articulate high-risk areas and translate what reputational risk means for their institution.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Senior leadership and middle management communicate and behave in a way that is consistent with corporate values, strategy and risk management, illustrated through:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Actions</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Behaviors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Formal and informal communications that strengthen key messages</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Middle managers reward employee behaviors when aligned with corporate values and address dysfunctional behaviors.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Employees can describe corporate values using examples that are relevant to their role.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Leadership and business units align budgets, performance targets and resourcing budgets to the tone from the top.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Employees are encouraged to engage in 360-degree feedback that is designed to expose questionable behaviors and provide a safe space for challenge across all levels in the institution.</td>
</tr>
<tr>
<td></td>
<td>Risk behaviors are established, assessed and embedded into the institution's performance management process</td>
<td>• Leadership communicates desired and unacceptable behaviors as defined through corporate values and risk management objectives, e.g., customer focus.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Staff can demonstrate an understanding of desired and unacceptable behaviors relative to their role in their self-assessment.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Individual performance is assessed through clearly defined metrics that are consistent with the institution's values.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Staff are progressed through the institution and compensated for actual behaviors as compared with desired behaviors.</td>
</tr>
<tr>
<td><strong>2. Risk governance and operating model support the delivery of appropriate behaviors, accountability and effective challenge</strong></td>
<td>Roles and responsibilities are clear and accountabilities for managing risk are understood</td>
<td>• All three lines of defense support effective risk management.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The first line of defense accepts accountability for the risks, including impact on reputation.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• All lines of defense play a role in ensuring appropriate behavior and are effective in their activities.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Businesses recognize they own the risks; they are accountable for the risks taken and what this means in the context of the institution's risk framework.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The institution recruits and retains people whose skills are aligned to the right positions and who can demonstrate an ability to escalate issues or challenge when required. All groups – the board, executive management, middle management, individuals – state that they are responsible for their own risk behaviors and will be held accountable.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Leadership rewards all staff for proactively reporting unacceptable behavior.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Accountability for risk, including reputational and operational, rests with the whole management chain, e.g., business units, committees and individuals.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Management provides business and support functions with appropriate levels of risk resources.</td>
</tr>
<tr>
<td>Mechanism (tools)</td>
<td>Risk culture attributes (outcomes)</td>
<td>Examples of risk culture indicators (behavioral statements)</td>
</tr>
<tr>
<td>---------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>
| Effective risk governance and open communication                                 | • Staff are provided with a safe platform from which they can share knowledge of risk events, including bad news, and discuss problems or issues so lessons are learned.  
• Management is approachable and open to receiving bad news and communicates this regularly.  
• Employees can identify their escalation routes and feel obliged to do so.  
• Cross-functional collaboration between risk and other functions is balanced and shows respect for risk.  
• There is openness and transparency with regulators. |                                                                                                                                 |
| 3. Risk management framework is embedded in the way the business manages risks   | Risk appetite is consistent with business strategy and embedded into business decisions                                 | • The business embeds risk appetite into all activities, highlighting reputation, operational and conduct risks, and sets strategies and targets that are consistent with the tone from the top.  
• The institution clearly defines the consequences when risk appetite and related limits are breached; severity of the consequence is balanced to encourage reporting. |
| Risk transparency through clear and comprehensive risk reporting                 |                                                                                                                     | • Leadership invests in quality systems to support robust information management and stress testing to enable decision-making.  
• Employees ensure management information is clear and robust and supports monitoring of risk and escalation of emerging issues.  
• Staff capture all forms of risk, including concentrations, conduct and reputation, through quality data and systems.  
• Leadership rewards staff for proactively communicating and escalating issues. |                                                                                                                                 |
| 4. Employee life cycle and incentives support the desired behaviors              | Employee life cycle – recruiting, onboarding, exiting processes promote desired behaviors with training programs supporting them | • The institution designs recruitment, onboarding and exit activities that emphasize corporate values and risk management objectives.  
• Business units implement these processes consistently across the institution and regularly monitor their operational effectiveness.  
• The institution assesses behavior that is integral to the recruitment and performance management process.  
• Employees can demonstrate how corporate values and risk management objectives apply to their daily responsibilities and are required to do so as part of their annual performance planning and assessment.  
• The institution provides and requires core training, professional development and assessment to ensure the bounds of acceptable and unacceptable behavior are understood.  
• HR supports the risk culture objectives of the institution. |                                                                                                                                 |
| Incentives – compensation and promotions are risk- and behavior-adjusted        |                                                                                                                     | • HR assesses behavior as a direct influence on compensation and promotion with clear consequences for dysfunctional behaviors.  
• Middle management and HR thoroughly consider evidence on values and attitude toward controls and risk appetite using forward-looking risk metrics, including softer risks.  
• The institution promotes individuals based on behaviors. |                                                                                                                                 |
Risk appetite
Firms focus on clarity and accountability throughout the enterprise

“How does the top-down risk appetite get translated accurately and effectively into a suite of limits that cause the businesses to do something they wouldn’t otherwise have done? Operationalizing the risk appetite simply has to be a top-down, bottom-up collaboration to work.”

An effective risk appetite framework, reinforced by a strong planning and risk governance process, is critical to developing and embedding an enterprise-wide risk culture. The FSB, in its 2013 risk governance peer review, *Thematic Review on Risk Governance*, and again in its November 2013 report, *Principles for an Effective Risk Appetite Framework*, makes clear the importance of integrating the risk appetite statement into a firm’s internal processes and embedding it into the risk culture. Industry executives agree. As one executive said, “Risk culture, risk appetite, business strategies, people and processes must all be aligned in order for it all to work effectively.” But many interviewees underscore the challenges they continue to face to achieve that integration and alignment. Despite the fact that risk appetite has been a top area of focus for both boards and CROs over the past several years, many firms are still finding it difficult to translate the firmwide risk appetite strategy into the day-to-day planning and operations of their businesses.

While close to one-third of this year’s respondents (31%) say they have successfully integrated risk appetite into the business units (a steady increase over the past three years), 58% report they continue to have difficulty moving the risk appetite approach further into their businesses. Interestingly, this percentage is up from last year’s (48%) and likely demonstrates a greater understanding of the requirements and challenges to truly embedding risk appetite (see Exhibit 11).

There are significant regional differences in banks’ views on their capacity to embed risk appetite into the businesses (see Exhibit 12). In both North America and Europe, most banks (63%) believe that although they are making good progress at an enterprise level, there is still some difficulty moving the approach into the businesses. This contrasts with Latin America, where 67% of respondents believe the risk appetite is embedded throughout the organization. This may reflect clearer expectations about what is required in some countries where supervisors have established a high bar for the risk
Survey results and discussions with executives point to four key factors critical to successfully cascading and embedding the firmwide risk appetite throughout the organization:

1. **Apply a top-down, bottom-up approach**

2. **Link risk appetite to day-to-day business strategy and planning**

3. **Clarify metrics**

4. **Establish clear reporting and accountability processes**

### Apply a top-down, bottom-up approach

The majority of the executives interviewed agree that successful execution of a firmwide risk appetite must be a collaborative top-down, bottom-up process. While it is the board that ultimately approves the risk appetite, its development must involve the CEO, CRO and CFO in discussion with business leaders. One bank executive made the point that “collaboratively agreeing on and establishing ‘the rules of the road’ is an important board and senior management exercise that builds commitment and enthusiasm among the leadership team and improves execution.”

---

**Exhibit 11:** Firms continue to work at integrating the risk appetite approach into business units

<table>
<thead>
<tr>
<th>Category</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good progress has been made at least at the enterprise/firm level, but we are having some difficulty moving the risk appetite approach further into the businesses</td>
<td>58%</td>
<td>48%</td>
</tr>
<tr>
<td>We have successfully determined, communicated, embedded and enforced the risk appetite into all businesses across the organization</td>
<td>31%</td>
<td>29%</td>
</tr>
<tr>
<td>We have made some progress but are still struggling to introduce a risk appetite framework even at the enterprise/firm level</td>
<td>10%</td>
<td>11%</td>
</tr>
<tr>
<td>We are planning our approach</td>
<td>0%</td>
<td>2%</td>
</tr>
</tbody>
</table>

appetite's integration into and influence on business decisions. Endorsed by G20 leaders, the FSB has been steadily increasing its supervisory expectations for risk management and for risk appetite in particular, especially for global systemically important financial institutions (SIFIs). As a result of the heightened pressure, the boards and senior management teams in these institutions have been working, as one executive said, “a little longer and a little harder” on risk appetite.

While regulators in some countries are putting greater pressure on banks to implement effective risk appetite frameworks, banks are also seeing internal benefits. Several executives commented on the value of the “journey” to determine the risk appetite parameters for the firm and the benefits of a unified plan and process. One described the upside of risk appetite planning for his firm: “Our 10-year effort to formalize and embed risk appetite has been an important factor in helping us through the crisis.”

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Another lesson from the programs in many banks is that the appetite has to be concrete as well as measurable and executable. Several executives whose firms have been successful in embedding risk appetite emphasized the need for the risk appetite framework to be simple and practical so that the businesses can understand and adapt it appropriately. As one interviewee explained, “The business leaders must believe in and agree with what is on the piece of paper and be willing and able to manage to it and monitor it. Otherwise it doesn’t work.”

**Link risk appetite to business strategy and planning**

The starting point for embedding risk appetite is linking it with strategy, and here the industry has made real progress. More than two-thirds of respondents have been successful in linking risk appetite to the annual firmwide business planning process, with 63% of respondents reporting significant linkage (up from 58% last year) and more than one-third (35%) reporting some linkage (see Exhibit 13). However, there is still considerable work to be done to truly manage and monitor the risk appetite linkage to day-to-day business decisions. Only 35% of respondents consider individual business decisions to be “largely” tested against risk appetite compared to more than half (56%) who say that most decisions are only “somewhat tested” (see Exhibit 14).

Closely tying financial planning and budgeting to risk appetite seems to be a key for several firms that are among those farthest down the path in linkage. As one executive explained, “The budgeting process is one of the most important ways to impose an alignment between risk and the business line. The businesses cannot present their revenue projections without proving that the new transactions they are proposing are compliant with the risk statement and the risk profile.”

Another essential aspect of linking risk appetite to business decisions is that the limits and controls at the business-unit level need to deliver the overall group risk appetite. One firm is requiring each of the businesses to develop its own risk appetite statement to deliver against the overall risk appetite, and with consistent metrics, but with more detail to more closely reflect the nuances of the business line.

Several discussed the importance of creating a “dynamic and responsive” risk appetite process. As one executive summed up, “The risk appetite is not something that you set once and it lives on for 250 years.”
Clarify metrics

Consensus is emerging on the key quantitative metrics to set and monitor risk appetite at the group level (see Exhibit 15). Seventy-six percent of banks use a forward loss metric (stress test results, loss in extreme events or earnings at risk) as a risk appetite metric at the group level. Eighty-three percent use a capital ratio, with a Tier 1 ratio gaining favor (71% compared with only 25% last year). In addition, most banks have liquidity measures (73%) and concentration or other limits. Given the high-profile operational failures in recent years, it’s not surprising that more than half of the study participants use operational losses as a metric. There was a large jump in the use of risk-weighted assets (RWA), from 13% of respondents last year to 50% this year, undoubtedly reflecting the focus on RWAs in view of the high-capital requirements of Basel III.
Exhibit 16: Primary metrics in monitoring risk appetite at the group level

- Capital ratios: 71% in 2014 and 71% in 2013
- Concentration limits: 69% in 2014 and 76% in 2013
- VaR: 67% in 2014 and 69% in 2013
- Limits: 64% in 2014 and 72% in 2013
- Operational losses: 53% in 2014 and 62% in 2013
- Funding/liquidity measures: 60% in 2014 and 69% in 2013
- Stress test results: 60% in 2014 and 69% in 2013
- RWA: 56% in 2014 and 62% in 2013
- Tier 1 ratio: 53% in 2014 and 64% in 2013
- Capital adequacy: 51% in 2014 and 53% in 2013
- Economic capital: 51% in 2014 and 59% in 2013
- ROE: 49% in 2014 and 50% in 2013
- Provisions: 38% in 2014 and 41% in 2013
- Loss in extreme events: 36% in 2014 and 36% in 2013
- Expected loss: 33% in 2014 and 48% in 2013
- Internal ratings: 22% in 2014 and 50% in 2013
- Cost of risk: 18% in 2014 and 33% in 2013
Shifting focus: Risk culture at the forefront of banking risk appetite. A forward loss metric of some kind (stress test results, earnings volatility or loss in extreme events) is now used at divisional level by 65% of banks compared with 49% last year. The use of risk-adjusted return on capital (RAROC) has decreased, reflecting the general reduction in reliance on economic capital models that under-read the risks prior to the crisis.

Several firms discussed their process for more accurately monitoring risks at the business-unit level. One firm, for example, has created a key risk indicator scorecard and risk map for each business unit, pinpointing key risks per

Exhibit 17: Metrics used to set or monitor risk appetite at the divisional level

- Concentration limits: 80% (2014), 85% (2013)
- Limits: 75% (2014), 91% (2013)
- VaR: 70% (2014), 67% (2013)
- Stress test results: 59% (2014), 44% (2013)
- RWA: 55% (2014), 61% (2013)
- Economic capital: 50% (2014), 52% (2013)
- Operational losses: 48% (2014), 52% (2013)
- Expected loss: 36% (2014), 50% (2013)
- RAROC: 34% (2014), 48% (2013)
- Earnings volatility: 19% (2014), 32% (2013)
- Internal ratings: 30% (2014), 44% (2013)
- Loss in extreme events: 30% (2014), 28% (2013)
business over a six-month period and tracking the frequency and severity of the different risks. Another bank is working from the bottom up to create detailed, measurable, easy-to-obtain and substantially predictable pre-risk indicators for each business. According to the executive interviewed, “We will watch these indicators until they have a certain level of maturity and credibility so that we are more comfortable setting limits.”

On the qualitative side, firms are striving to balance internally driven goals — business goals, board viewpoints, strategic and reputational goals, and organizational philosophy, culture and value parameters — with expectations from external stakeholders, including regulators, rating agencies, investors, counterparties and customers (see Exhibit 18). Interestingly, in line with the general trend of greater focus on risk culture, this issue has become a more important qualitative factor affecting the setting of risk appetite, and investors, counterparties and customers are playing a smaller role.

**Establish clear reporting and accountability processes**

Tracking, reporting and holding people accountable were all cited as critical to embedding and managing risk appetite. Fifty-six percent of respondents reported significant progress over the past 12 months in their ability to track and enforce adherence to risk appetite, an increase from 48% last year (see Exhibit 19). There was general agreement that adherence to risk appetite must be formally tied to compensation to be effective. As one executive explained, “To give it teeth, you have to embed the risk appetite into the compensation structure of the bank. We are taking pains to include risk appetite assessments in the compensation process.” Another bank has developed a formal monitoring process driven by the CRO and the chair of the risk committee. Every quarter, performance against risk appetite parameters is evaluated for all business leaders and top earners in the bank. At year-end, the CRO presents a 12-month scorecard to the risk

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**Exhibit 18: Qualitative issues affecting setting of risk appetite**

<table>
<thead>
<tr>
<th>Issue</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business goals</td>
<td>81%</td>
<td>77%</td>
</tr>
<tr>
<td>Views of the board</td>
<td>75%</td>
<td>77%</td>
</tr>
<tr>
<td>Reputation</td>
<td>73%</td>
<td>69%</td>
</tr>
<tr>
<td>Organizational philosophy, culture and values</td>
<td>65%</td>
<td>73%</td>
</tr>
<tr>
<td>Strategic goals</td>
<td>71%</td>
<td>76%</td>
</tr>
<tr>
<td>Expectations of regulators</td>
<td>69%</td>
<td>68%</td>
</tr>
<tr>
<td>Ratings agencies</td>
<td>54%</td>
<td>50%</td>
</tr>
<tr>
<td>Market conditions</td>
<td>52%</td>
<td>55%</td>
</tr>
<tr>
<td>Investors</td>
<td>47%</td>
<td>40%</td>
</tr>
<tr>
<td>Competitive environment</td>
<td>39%</td>
<td>31%</td>
</tr>
<tr>
<td>Counterparties/customers</td>
<td>35%</td>
<td>27%</td>
</tr>
</tbody>
</table>

(25) 2014 Risk management survey of major financial institutions
Virtually all of this year’s respondents are conducting regular reviews of the risk appetite in their organizations. While 65% report annual formal review processes, a growing number of institutions, particularly the global SIFIs, are conducting more frequent reviews on a quarterly, monthly and, according to one executive, “a day-by-day, transaction-by-transaction basis.”

More and more firms are embedding risk appetite discussions into their regular board and senior-level committee meetings. As one executive told us, “It’s the first thing on the agenda at every board risk committee meeting throughout the year.” Regardless of the frequency, the majority agree that the review and assessment of the firm’s risk profile against its risk appetite must be an ongoing and iterative process.

All agree that embedding risk appetite requires attention to all of the activities discussed throughout this report: shifting the cultural mindset around risk; strengthening governance structure roles and responsibilities; adjusting performance requirements and compensation; and upgrading systems and processes to test, track, report and assess progress. For most, the process is a long-term effort to develop and implement, and sustaining it over time is an ongoing journey.

management committee to determine bonus accruals and major awards and to make certain there are no violations of the risk appetite statement.

Several executives described clearly defined escalation processes for breaches; these include documentation, reviews and discussions to assess each occurrence, and when the breach is deemed inappropriate, real consequences to those involved. As one executive told us, “For our organization, adherence to risk appetite can make or break careers, so it’s a self-fulfilling goal.”

Exhibit 19: Banks report significant progress in ability to track and enforce adherence to risk appetite

<table>
<thead>
<tr>
<th>Status</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significant progress</td>
<td>56%</td>
<td>48%</td>
</tr>
<tr>
<td>Moderate progress</td>
<td>35%</td>
<td>35%</td>
</tr>
<tr>
<td>In the early stages</td>
<td>8%</td>
<td>13%</td>
</tr>
</tbody>
</table>
Financial Stability Board key definitions used for risk appetite

**Risk appetite framework (RAF):**

The overall approach, including policies, processes, controls and systems through which risk appetite is established, communicated and monitored. It includes a risk appetite statement, risk limits, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF. The RAF should consider material risks to the financial institution, as well as to the institution’s reputation vis-à-vis policyholders, depositors, investors and customers. The RAF aligns with the institution’s strategy.

**Risk appetite statement:**

The articulation in written form of the aggregate level and types of risk that a financial institution is willing to accept, or to avoid, in order to achieve its business objectives. It includes qualitative statements, as well as quantitative measures expressed relative to earnings, capital, risk measures, liquidity and other relevant measures, as appropriate. It should also address more difficult to quantify risks, such as reputation and conduct risks, as well as money laundering and unethical practices.
**Risk capacity:** The maximum level of risk the financial institution can assume, given its current level of resources, before breaching constraints determined by regulatory capital and liquidity needs, the operational environment (e.g., technical infrastructure, risk management capabilities, expertise) and obligations, also from a conduct perspective, to depositors, policyholders, shareholders, fixed income investors and other customers and stakeholders.

**Risk appetite:** The aggregate level and types of risk a financial institution is willing to assume within its risk capacity to achieve its strategic objectives and business plan.

**Risk limits:** Quantitative measures based on forward-looking assumptions that allocate the financial institution's aggregate risk appetite statement (e.g., measure of loss or negative events) to business lines, legal entities as relevant, specific risk categories, concentrations and, as appropriate, other levels.

**Risk profile:** Point-in-time assessment of the financial institution's gross and, as appropriate, net risk exposures (after taking into account mitigants) aggregated within and across each relevant risk category based on forward-looking assumptions.

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1 *Principles for an Effective Risk Appetite Framework, 18 November 2013.*
Risk governance

Firms tighten controls at both board and management levels

“Are we managing risks or are we managing regulations? What is the right balance to strike between prudence and capital efficiency?”

Boards and senior management are facing growing scrutiny and pressure from regulators, the media and the public to tighten internal controls and reduce high-risk behavior. The impact of rising litigation costs, steep fines and reputational damage has been a catalyst for firms to re-evaluate and strengthen their risk governance frameworks. For some, these changes are part of major firmwide transformation initiatives, while for others, they are more focused efforts to better identify and manage the myriad risks inherent in the business. As one CRO explained, “There are many low-frequency, potentially high tail risks lurking within our business practices – in product design, disclosure, conflict of interest and so on. We have to improve our ability to oversee these risks and govern top-down as well as in day-to-day functions and control routes in the business lines.”

While there was considerable discussion around the risk governance changes underway in each firm, several recurring initiatives emerged in our interviews:

- Boards are adding new committees to more closely monitor business ethics, conduct and, in particular, product suitability.
- Internally, firms are restructuring – streamlining and integrating current management committees, adding new committees and functions – to break down silos and close the gaps in risk oversight and control.
- The risk function is playing a more significant role in compliance.

**New board committees are being added to monitor ethics and conduct**

As in previous years, board oversight of risk remains strong, with 44% of all respondents reporting an increase in board focus over the past 12 months (see Exhibit 20). Banks in Africa and the Middle East reported the greatest growth in focus this past year, at 83%, up from 50% last year. Over half (56%) of
survey respondents indicated ongoing sharpened board focus on risk management since the financial crisis. As was the case last year, almost all the North American banks in the sample (88%) judged themselves to have heightened the focus on risk after the crisis, and it remains high. The trend in other regions is for more banks to have increased their focus on risk in the past 12 months.

The interesting news this year is the number and mandate of new board committees that have been formed to more effectively oversee firmwide ethics, reputation risk and conduct. According to several executives interviewed, there has been a considerable investment on behalf of the boards to more deeply assess and oversee specific risk types that have not historically received much attention at the board level. As one executive told us, “Everyone wanted to talk about credit risk first, then market risk second, and then funding and liquidity third, and we weren’t spending enough time on the other risks.”

Several firms have either reorganized current risk committees or added new, more risk-specific committees. For example, one bank formed a new umbrella committee responsible for enterprise-wide risk management and split its former risk committee into two separate bodies, one concentrating on financial risk, including credit and market risk and funding, and the other on conduct, reputation and operational risk. To emphasize its importance, this group is headed by the chairman of the bank.

Another firm recently added two new committees, a financial system vulnerability committee that oversees financial crime, money laundering and sanctions, and a conduct and values committee. And yet another firm has formed a supervisory board integrity committee that monitors cultural transformation and legal and reputational risks, as well as the bank’s code of ethics. Taken together, these changes represent a significant shift in board governance and attention to non-financial risks.

Exhibit 20: Board focus on risk remains high post-crisis

<table>
<thead>
<tr>
<th>Region</th>
<th>Focus on Risk</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>44%</td>
<td>56%</td>
</tr>
<tr>
<td>Africa/Middle East</td>
<td>17%</td>
<td>83%</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>38%</td>
<td>56%</td>
</tr>
<tr>
<td>Europe</td>
<td>44%</td>
<td>56%</td>
</tr>
<tr>
<td>Latin America</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>North America</td>
<td>12%</td>
<td>88%</td>
</tr>
</tbody>
</table>

* The focus was increased post-crisis and remains high
* The amount of focus on risk matters has increased this past year

Board influence widens as regulatory pressures increase

Survey results show a wide range of areas where the board now plays an influential role in the organization. Eighty percent of interviewees listed risk appetite as the area where the board is most influential, followed by risk compliance (68%), liquidity risk (66%) and reputational risk (66%). However, reflecting the increasingly broad purview of boards, more than 50% listed an impressive number of additional areas where the
board has impact and influence. These include credit risk, capital allocation, risk culture, stress testing, asset liability management (ALM) risk, and operational and market risk (see Exhibit 21).

There was considerable discussion of the growing pressure and accountability boards are facing from regulatory mandates and expectations. Many believe that the increasing time commitment, complexity of the regulations and the overall day-to-day demands on boards are unrealistic and burdensome – so much so that, as one CRO put it, “it could soon become very difficult to find board members willing to serve.” One interviewee described a day in the life of board members: “In the morning they spend three to four hours in a committee meeting, then they meet somewhere in the bank for a special face-to-face briefing on a specific topic – like cyber security in our technology center where they can see it in action – then they have reams of reports to read to stay abreast of developments. Plus, our regulator expects each one of them to present periodically on various topics. It’s getting closer and closer to a full-time commitment.”

To better adapt to the multiplying regulatory requirements, many firms have steadily added new skills and expertise to their boards. In the past year, 40% added members with risk expertise and 38% added members with knowledge of banking (see Exhibit 22). Some respondents predicted that banks could be forced to appoint more and more bankers to the board, which would reduce the diversity of experience and thinking. As one interviewee explained, “The regulators don’t want all bankers on the board, yet they expect non-bankers to have expert knowledge on running the business – it’s a conflicting requirement.”

Exhibit 21: Areas where the board is most influential

<table>
<thead>
<tr>
<th>Area</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk appetite</td>
<td>80%</td>
</tr>
<tr>
<td>Risk compliance</td>
<td>68%</td>
</tr>
<tr>
<td>Liquidity</td>
<td>66%</td>
</tr>
<tr>
<td>Reputational risk</td>
<td>66%</td>
</tr>
<tr>
<td>Credit risk</td>
<td>64%</td>
</tr>
<tr>
<td>Capital allocation</td>
<td>58%</td>
</tr>
<tr>
<td>Risk culture</td>
<td>58%</td>
</tr>
<tr>
<td>Stress testing</td>
<td>54%</td>
</tr>
<tr>
<td>ALM risk</td>
<td>52%</td>
</tr>
<tr>
<td>Operational risk</td>
<td>52%</td>
</tr>
<tr>
<td>Market risk</td>
<td>50%</td>
</tr>
<tr>
<td>Risk technology/architecture</td>
<td>34%</td>
</tr>
<tr>
<td>Insurance risk</td>
<td>26%</td>
</tr>
</tbody>
</table>
As in previous years, interviewees expressed concern about the increasingly blurred lines between board and management responsibilities. A number of respondents worry that the regulators have gone too far in involving the board in day-to-day management issues. One executive noted, “The board is specifically intended to be separate from management so they can provide oversight to the decisions made by management. If they start acting like management, they are unable to do the second-guessing.” Many are frustrated with the still-evolving expectations of the regulators on the division of roles and responsibilities. As one executive told us, “To be honest, regulators are not yet clear what they want from the boards versus the management team – there is still an element of trial and error in the process, which is challenging.”

Restructuring to close gaps in control or break down silos

A range of other changes to risk governance processes have been put in place to enhance risk control. Some institutions have streamlined and integrated current management committees to reduce duplication, break down silos and centralize control. Others have added new committees and/or functions to close the gaps in risk identification and management. And several firms described steps to clarify and refine overall processes in compliance, assurance and lines of defense.

One bank eliminated more than 100 committees across the enterprise to create a “more centralized, board-linked risk governance process tightly controlled by the senior management team.” Another bank consolidated three executive-level committees – credit, operational and market risk – into one committee composed of a cross-section of key executives and managers to “reduce isolation and silos and look at initiatives and strategies on an integrated and more efficient basis.” Yet another firm has created new enterprise-level positions responsible for major risk types. As one interviewee explained, “We had market risk oversight at the corporate, treasury and consumer level, but we didn’t have anyone with a bird’s-eye view of the entire risk type across the organization.”

A number of firms are strengthening compliance by creating new committees and shifting responsibility to the CRO. One bank split its compliance function into two groups – one focused on global regulatory compliance and the other on crime compliance. Both groups have newly hired leaders, who both report to the CRO. Another firm merged its operational risk control team with its compliance team and shifted the whole function out of legal to report to the CRO. And still another firm has merged its audit and compliance functions to “consolidate data and systems, leverage synergies and centralize management under one umbrella.”

Several firms indicated they are in the process of refining their three lines of defense to further clarify the division of responsibility. This is partly to enhance the independence of the risk functions. In one bank, for example, the regulators had seen the risk function as overly influenced by finance. A much more common issue is how non-financial risk types should be treated to create fully independent second-line oversight. One firm has reorganized all of its second line of defense risk management under the CRO to centralize control and create
more transparency throughout the organization. Another aim is streamlining, standardizing and documenting control systems and processes across the organization to increase consistency and transparency, while yet another, discussed earlier in the report, is to increase front-line accountability for risk.

The role of the CRO and the risk function continues to expand

Unquestionably, for most of the firms in this year’s study, the role of the CRO is continuing to expand its focus and responsibility. In addition to taking on more responsibility for compliance, CROs and their skilled risk teams are thoroughly involved throughout the firmwide strategic decision-making process.

When asked to list the top issues requiring the most CRO attention during the past year, participants named a host of risk-related areas. While credit risk remains the top focus of the risk function (58%), that focus has decreased somewhat this year. Not surprisingly, risk appetite (56%), operational risk (50%), regulatory compliance (50%) and enhancing risk controls (32%) have all risen fairly significantly on the CRO agenda compared to last year (see Exhibit 23). Risk appetite is definitely a key concern for both boards and the risk team and is, as one CRO told us, “clearly back at post-crisis level” in terms of attention and effort. In fact, many executives agreed that regulatory compliance has, as one interviewee remarked, “completely swamped the CRO role.” Interestingly, the focus on liquidity risk, which was close to the top of the chart in our 2012 report, has continued to diminish over the past two years, reflecting the easing of liquidity pressures.

Several executives discussed the growing time and effort CROs must expend on building and managing their teams, given the complex regulatory environment and expanded role of risk functions. Attracting, retaining and appropriately deploying the risk talent pool is a key responsibility for the CRO. As one executive told us, “Ensuring an adequate talent base, and keeping everyone focused, happy and productive, requires strong HR planning and management, a competitive compensation plan, good communication skills and lots of time.”

Executives reported a number of internal changes within their risk functions to respond more efficiently to regulatory demands, spot emerging risks and support firmwide initiatives. For most, these changes reflect the efforts discussed throughout this chapter to tighten controls and further strengthen risk governance across the organization. Changes discussed included initiatives to shore up specific risk types, such as operational and IT risks, and new processes to tackle regulatory reform. One bank, for example, has added a new management office to concentrate specifically on information systems and regulatory reporting requirements. Many are increasingly concerned about risk identification and are reviewing their team structures to close the gaps in coverage. One CRO has added a chief operating officer function to his team to focus on risk types like conduct and reputational risk and topics such as risk appetite and risk culture, which “fall between the risk columns.”

Most of these adjustments to the risk function have involved newly created positions and teams that have, in turn, required new hires. As Exhibits 24 and 25 show, 57% of banks reported an increase in the size of the group risk function over the past year. This is up from last year’s response (44%) and indicates a return to the 2012 growth level. And, as in previous years, respondents predict an expansion in the size of the function over the next year, with more than 50% anticipating a continued hiring trend.

Regarding the greatest challenges for CROs, most cited the ongoing challenges of the evolving regulatory environment. As one CRO summed up, “keeping up with the constant, ever-changing expectations from both public policymakers and the supervisors is an unrelenting challenge for the risk team.” The stress on costs, resources and management time to meet the growing granularity of the regulatory demands and reporting requirements are raising concerns for interviewees. Many discussed the challenges of striking the right balance between managing risk and managing regulations. All agree that incorporating regulatory requirements into the strategy and day-to-day operations of the business is difficult, and many worry they are being pulled more and more into the role of “chief regulation officer” at the expense of the business.

Undoubtedly, CROs have a full plate of responsibilities and challenges, from regulatory demands to day-to-day people management. But, throughout our discussions this year, it was very clear that CROs today play an important and respected role on the firmwide senior executive team. As one interviewee expressed it, “Being a CRO these days isn’t a job, it’s a calling.”
Exhibit 23: Top issues requiring most CRO attention

- Risk transparency: 8% (2014) vs. 7% (2013)
- Counterparty risk: 6% (2014) vs. 7% (2013)
- Compensation: 6% (2014) vs. 5% (2013)
- Treating customers fairly (TCF): 4% (2014) vs. 5% (2013)
- Insurance risk: 2% (2014) vs. 0% (2013)
- Systemic risk: 0% (2014) vs. 3% (2013)
- Accounting and valuation: 0% (2014) vs. 2% (2013)

- Credit risk: 58% (2014) vs. 66% (2013)
- Risk appetite: 56% (2014) vs. 49% (2013)
- Operational risk: 41% (2014) vs. 50% (2013)
- Regulatory compliance: 32% (2014) vs. 50% (2013)
- Enhancing risk controls: 30% (2014) vs. 23% (2013)
- Regulatory capital management: 33% (2014) vs. 30% (2013)
- Market risk: 31% (2014) vs. 26% (2013)
- Liquidity risk: 38% (2014) vs. 26% (2013)
- Stress test strategy: 28% (2014) vs. 26% (2013)
- Risk architecture (systems and data): 26% (2014) vs. 22% (2013)
- Reputational risk: 21% (2014) vs. 16% (2013)
- Recovery and resolution planning: 20% (2014) vs. 16% (2013)
- Model validation: 21% (2014) vs. 16% (2013)
- Cyber security risk: 10% (2014) vs. 10% (2013)
- Economic capital allocation: 16% (2014) vs. 10% (2013)
Exhibit 24: Changes in size of group risk function in past year

- Increased: 57% in 2014, 44% in 2013
- Decreased: 16% in 2014, 24% in 2013
- No change: 27% in 2014, 31% in 2013

Exhibit 25: Anticipated change in size of group risk function next year

- Increased: 53% in 2014, 44% in 2013
- Decreased: 12% in 2014, 21% in 2013
- No change: 35% in 2014, 34% in 2013
Shifting focus: Risk culture at the forefront of banking
Operational and conduct risk management

Firms are reviewing processes and strengthening controls across the enterprise

“Operational risk and operational risk losses, together with conduct risk, are major areas of focus and initiatives for our firm.”

Given the major operational failings that have come to light across the industry in recent years, it was not surprising that 92% of respondents report increased attention to and assessment of operational risk management over the past 12 months. For most, operational risk is a large catch-all category of many types of risk. As one executive told us, “Everything is in operational risk, from cyber security to earthquakes.” However, when asked to prioritize the principal areas of focus, 74% of respondents placed regulatory risk at the top of the list, followed closely by conduct risk (65%), systems risk (also at 65%) and reputational risk (53%).

Exhibit 26: Operational risk areas of enhanced focus

- Regulatory risk: 74%
- Systems risk: 65%
- Conduct risk: 65%
- Reputational risk: 53%

Operational losses tied to lack of control

When asked to analyze their losses from operational failures, one-quarter of the study participants reported a loss of more than US$500 million in the past five years (see Exhibit 27). While 84% indicated that these losses fell within the amount of capital held for operational risk (see Exhibit 28), 76% indicated that the losses they experienced were the result of weak management oversight and controls (see Exhibit 29). Strikingly, only 27% said there was a scenario assessment for the type of risk leading to the loss prior to the event, and only 14% had noticed that the risk was rising prior to the event. Interviewees agreed that the capital consequences for, as one executive put it, “getting it wrong,” have skyrocketed.
Shifting focus: Risk culture at the forefront of banking

Responsibility for operational risk is shared throughout the organization

Seventy-nine percent of respondents reported that the business unit and front desk are responsible for the day-to-day management of operational risk performance (see Exhibit 30). As one executive told us, “We always try to give the risk responsibility to the person who is already in charge of the situation.” Nonetheless, under the accountability changes some firms are putting in place, this responsibility is being formalized and control structures are being enhanced in the front office to ensure that non-financial risks are controlled and assessed more effectively.

The operational risk function in many banks has been more focused on how to calculate capital numbers than on providing a true forward risk assessment. But now, the role of the operational risk units is changing. Several firms reported newly appointed operational risk directors and teams who report into the CRO, as well as a change in their remit. One firm appointing a new head said, “Operational risk has traditionally been something that is logged and studied after a loss event.”

Exhibit 27: The majority report their largest loss in the past five years was less than US$500m

<table>
<thead>
<tr>
<th>Loss Amount</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $5b</td>
<td>74%</td>
</tr>
<tr>
<td>$1-$5b</td>
<td>12%</td>
</tr>
<tr>
<td>$5-$10b</td>
<td>10%</td>
</tr>
<tr>
<td>$10+</td>
<td>2%</td>
</tr>
</tbody>
</table>

Exhibit 28: Majority stated their largest loss was within the capital held for operational risk

- The loss was within the capital held for operational risk: 84%
- There was a scenario assessment for this type of risk prior to the event: 27%
- Analysis of a similar scenario helped in the event management or had resulted in controls that mitigated losses: 18%
- Leading indicators/key risk indicators (KRIs) had indicated that the risk was rising: 14%
- Leading indicators/KRIs had picked up the risk that an event could occur: 7%
Firms activate several key initiatives to refine and strengthen operational risk management

Respondents reported a host of activities underway to strengthen operational risk management. Sixty-three percent indicated they are working to enhance operational controls across the enterprise. More than half are improving data collection, and more than one-third are improving scenarios and modeling and strengthening conduct controls (see Exhibit 31). While there was considerable discussion on the specific initiatives to strengthen operational risk strategies and processes, two key points emerged from our interviews:

1. Looking forward versus after-the-fact is a key analysis goal.

Prevention of operational risk versus after-the-event analysis surfaced as an important goal for many study participants. As one executive told us, “Avoidance is our mantra.” Interviewees described simulation and modeling processes to better forecast and prevent events before they occur; environmental scans to understand the nature of breaches throughout the financial services industry; deep drill-downs and evaluations of near-miss events to tighten controls; undercover surveillance teams to observe front-line behavior; whistle-blowing hotlines; and employee training and management programs to improve accountability and enhance performance.
2. Losses are important opportunities to refine and adjust processes and controls.

While avoidance is the goal, all participants agreed there are important lessons to be learned from loss events. Several described detailed loss reporting procedures and forensic investigative processes to analyze how and why the events occurred and to identify fundamental and/or incremental weaknesses in individual processes that require adjustments to controls.

Conduct risk management is a high priority

Given the heightened regulatory and public attention to misconduct in the industry, many firms reported special initiatives aimed specifically at strengthening conduct risk processes and controls. Sixty percent of respondents cited reputational damage as their highest risk from breakdowns in conduct management, followed by the costs associated with regulators’ fines and remediation and legal suits by investors or counterparties (see Exhibit 32).

Exhibit 32: Reputational damage, costs among areas of highest concern for conduct risk

Responsibility for conduct risk varied among the banks interviewed. For some, the head of compliance is responsible, while for others, conduct risk falls under the operational risk team’s umbrella, reporting into the CRO. Still others assign the responsibility to the business unit leaders. Many agreed that conduct risk is a diffuse and complex issue and must ultimately be watched and managed by a cross-functional team of leaders throughout the organization.

Exhibit 33 shows the range of initiatives underway across most banks to enhance control of conduct risk. Most are strengthening compliance at the group and business unit level and increasing oversight of both group risk and internal audit functions. In line with the accountability discussion elsewhere in this report, most are making business units primarily responsible but are also conducting reviews of controls. Several banks discussed initiatives to improve product development procedures to make certain that products are appropriate and fair to customers, as well as compliant with regulatory risk conduct requirements.

Treating customers fairly was an important topic of discussion for many of our interviewees. The wide variety of mis-selling cases in both the US and the UK and heightened scrutiny from a number of authorities has directed attention to this aspect of conduct in particular. The UK’s Financial Conduct Authority (FCA) has made it clear that it is determined to create a culture of good conduct at every level of the financial services industry to “make markets work well and to produce a fair deal for customers.” The Monetary Authority of Singapore (MAS) has issued “fair dealing guidelines” that focus on multiple aspects of the product development and front-line sales processes to ensure that customers are being offered suitable products and understandable communications.

Several participants discussed the challenges of complying with what one executive described as “the new frontier” of regulatory requirements. One interviewee explained his perspective: “Unlike liquidity rules and capital ratios, conduct risk is much trickier and difficult to manage. For example, treating customers fairly, how do you judge that? Is it 100% of what we are trying to achieve? Is 80% acceptable? Is 40% a failure mark? What metrics and processes do you need to have in place to measure how well you are doing?”
Exhibit 33: Range of actions underway to strengthen conduct controls

<table>
<thead>
<tr>
<th>Action</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strengthening the compliance function at group level</td>
<td>67%</td>
</tr>
<tr>
<td>Making business units responsible</td>
<td>65%</td>
</tr>
<tr>
<td>Conducting reviews of controls</td>
<td>65%</td>
</tr>
<tr>
<td>Increasing oversight from group risk</td>
<td>61%</td>
</tr>
<tr>
<td>Strengthening business line compliance functions</td>
<td>59%</td>
</tr>
<tr>
<td>Increasing focus on new products</td>
<td>48%</td>
</tr>
<tr>
<td>Increasing focus on new customers</td>
<td>37%</td>
</tr>
<tr>
<td>Enhancing focus from internal audit</td>
<td>30%</td>
</tr>
<tr>
<td>Changing incentives</td>
<td>26%</td>
</tr>
</tbody>
</table>
Shifting focus: Risk culture at the forefront of banking
Internal stress testing
Integration and consistency are primary areas of focus

“Stress testing has become more quantitative, more holistic, more consistent and easier to replicate.”

Since the 2008 crisis, stress testing has evolved from what one executive called “an ad hoc exercise” to what is now a regular risk management practice. While the crisis was certainly the catalyst for substantial industry-wide upgrades to stress testing methodologies, the process of strengthening forecasting models, systems and procedures has become a focal point for ongoing senior management attention and investment. As one interviewee told us, “In 2008 and 2009, we had to develop our stress testing techniques in the midst of battle, under very tough conditions and with a very short time scale. We probably developed stress testing more in the first four months of 2009 than we had done in the previous 10 years. Now we are in a continuous process of refinement and improvement.”

Survey results and interview discussions indicate that banks are continuing to improve stress testing methodologies and frameworks and are working to link stress testing results with business planning and limit setting. Seventy-one percent of respondents reported they have created new internal stress testing methodologies in the past 12 months, an increase from 63% in last year’s report (see Exhibit 34). As one executive explained his firm’s efforts, “Every year we continue to refine our stress testing methods, looking for more efficient and more accurate ways to conduct tests and analyze results. We’re always trying to keep it simple enough to understand and communicate to the senior management team.”

Two key areas of ongoing improvement surfaced in this year’s discussion with the executives interviewed:

1. Increased focus on balance sheet and P&L

Many of the themes are a continuation of those in previous surveys, for example, integration of stress testing across a group and across risk types. Some respondents feel real progress has been made. An executive from one bank said, “In the past our stress testing process was very fragmented and difficult to aggregate. Now we are able to measure our
A new emphasis is that stress testing is becoming much more comprehensive, encompassing the entire profit and loss (P&L) and balance sheet rather than just the losses in the credit and trading books. Several firms indicated they are working to link stress testing to financial planning – improving their balance sheet and income statement forecasting and testing financial planning under stress scenarios in addition to baseline economic conditions. As one executive told us, “We are now stressing everything that could change in an adverse environment, including capital demand, capital supply, the P&L and the liquidity of the bank – it’s an extremely holistic approach.”

2. Central stress testing teams being created

Several executives discussed significant restructuring initiatives and investments in manpower to create centralized departments that focus exclusively on stress testing. One described a new, “incredibly robust” stress testing department that conducts monthly stress tests that are reported to the board and embedded into key decision-making. Another firm has formed an internal department that works closely with its research and finance teams to create and analyze different scenarios that could affect the bank. The stress test teams are also being upgraded. According to the executive interviewed, “We needed to upgrade our stress testing team from a bunch of backroom geeks to include people with the ability to engage with the business and who can truly understand what we need to look for and what the results tell us from a management viewpoint.”

Key risk and management focal points for stress testing are evolving

The largest change from last year is the down-weighting of liquidity risk as a top area of focus (see Exhibit 35). While it is still the second most-important area where the focus on stress testing has been heightened, it is now the case in only 65% of banks compared to 83% last year. This is likely the result of the Basel III liquidity stress testing requirements being more embedded now. Not surprisingly, given our discussions throughout this report, focus on operational risk has grown for many respondents.
Exhibit 35: Credit remains top risk area where focus on internal stress testing has increased in the past 12 months

- Credit: 2014 - 81%, 2013 - 86%
- Liquidity: 2014 - 65%, 2013 - 83%
- Market: 2014 - 60%, 2013 - 62%
- Operational: 2014 - 44%, 2013 - 41%
- Counterparty: 2014 - 38%, 2013 - 40%
- Regulatory: 2014 - 33%, 2013 - 33%
- Country: 2014 - 31%, 2013 - 26%
- Insurance: 2014 - 13%, 2013 - 9%
- Reputational: 2014 - 13%, 2013 - 12%
This year’s study shows a jump in the use of stress testing for capital planning, which was widely found last year but is now almost universal (see Exhibit 36), and more banks are also using it for capital allocation to businesses. The role of stress testing has also increased for risk appetite development and management and recovery and resolution. Some banks, particularly in the US, highlighted the huge effect that supervisory-driven stress tests are having on the capital required by regulators, overriding internal assessments.

One executive described his organization’s process for linking stress testing severity to various decisions: “We have a framework that looks at three levels of stress tests. The first looks at volatility of earnings within the strategies that we’ve put in place, which informs business planning. The second involves extreme stress testing within our risk appetite – the 1 in 99-year event – which informs our capital strategy. And the third involves reverse stress testing, which links to our recovery and resolution planning.”

Still, survey results this year indicate that stress testing continues to be undervalued as a guide to major business decisions. Only 35% of respondents reported that stress testing is incorporated into business unit planning, down from 40% last year (see Exhibit 36), and while the numbers have improved since last year, half of this year’s participants report that stress testing is still only “somewhat incorporated” into strategic management decision-making (see Exhibit 37). As one executive noted, “What’s our biggest challenge to stress testing? Using the results.” Many are working to embed stress testing into the strategic thinking and planning process. One firm will not approve business plans and budgets that do not incorporate adequate stress tests and scenarios. As the interviewee explained, “Whenever a new business strategy and plan are presented, we insist that they include several scenario outcomes. We then decide if the budget is adequate to cover the potential risks.”

The major change since last year with respect to methodologies for stress testing is the creation of granular, central stress testing models, at 56% compared with 41% last year (see Exhibit 38). Meanwhile, the role of economic capital models continues to fall (now down to 27% from 31% last year).

**Exhibit 36: Areas where stress testing is incorporated**

<table>
<thead>
<tr>
<th>Area</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital planning</td>
<td>96%</td>
<td>81%</td>
</tr>
<tr>
<td>Risk management</td>
<td>90%</td>
<td>95%</td>
</tr>
<tr>
<td>Risk appetite development and management</td>
<td>79%</td>
<td>71%</td>
</tr>
<tr>
<td>Recovery and resolution planning</td>
<td>58%</td>
<td>48%</td>
</tr>
<tr>
<td>Capital allocation to business units/entities</td>
<td>46%</td>
<td>37%</td>
</tr>
<tr>
<td>Business unit planning</td>
<td>35%</td>
<td>40%</td>
</tr>
<tr>
<td>Decisions on acquisitions</td>
<td>19%</td>
<td>26%</td>
</tr>
<tr>
<td>Decisions on new products</td>
<td>4%</td>
<td>16%</td>
</tr>
</tbody>
</table>
Exhibit 37: Extent to which stress testing is incorporated into strategic decision-making

- Significantly incorporated: 41% (2014), 39% (2013)
- Somewhat incorporated: 49% (2014), 55% (2013)
- Not incorporated: 8% (2014), 6% (2013)

Exhibit 38: Banks are using a variety of methods for running internal stress testing

- Setting the scenario across countries and business units and calculating the effect for each portfolio/business line: 79% (2014), 83% (2013)
- Stressing internal ratings-based (IRB) models for credit portfolios using average probability of defaults and loss given defaults per portfolio: 56% (2014), 61% (2013)
- Central stress testing models: 56% (2014), 56% (2013)
- Use of other business unit risk models: 38% (2014), 29% (2013)
- Stressing IRB models for sub-portfolios: 31% (2014), 36% (2013)
- Running the economic capital model to a higher confidence level (i.e., greater severity): 27% (2014), 31% (2013)
- Use of roll rate models in business units: 21% (2014), 17% (2013)
Another change in terms of scenario planning is the increased use of reverse stress testing (56% of banks, up from 45% last year), increased involvement of the business in identifying key risks and stresses (73%, up from 60%) and increased inclusion of operational risk events (48% against 42% last year), as shown in Exhibit 39.

Several participants discussed the formation of cross-functional teams of economists, business people and the risk team to think through the evolving issues to be considered in each business line. One of the firms interviewed requires the businesses to conduct their own stress tests, tailored to their own portfolios, which are then rolled up into the corporate stress test. As the firm’s executive explained, “Having the businesses conduct their own stress testing has helped focus their attention on potential risks that could impact their businesses, which has in turn informed their strategic planning and decision-making.”

The time to complete a group-wide stress test continues to be a pain point for many banks; for most, it takes one to two months (see Exhibit 40). Many believe that the time it takes to get results is a barrier to using the output as an effective management tool, although some say that results produced quickly are not comprehensive. Most agree that automating what is often a manual process of conducting tests and gathering results across portfolios and businesses would yield results more quickly and more cheaply and make them more useful as management tools.

**Top challenges reflect the complexity of stress testing**

Extracting and aggregating data continues to be the top challenge to improving stress testing, followed by a shortage of resources and inadequate systems (see Exhibit 41). Finding and aggregating accurate, quality data from siloed legacy systems have been ongoing issues for the industry for many years. While many have made significant progress, it is a massive, multiyear and costly endeavor. Many banks highlighted the effect of regulatory data and stress testing requirements, particularly the US Comprehensive Capital Analysis and Review (CCAR), on the capacity to run stress tests driven by internal needs. The regulatory tests can monopolize resources, particularly at global banks that must meet a variety of different stress testing requirements from multiple authorities.

And while there has undoubtedly been significant progress in strengthening stress testing methods and procedures, most interviewees acknowledged that it is a long-term project. As one executive explained, “In the absence of a stress testing machine, there are an awful lot of people that have to apply judgment to the process, and of course, those judgments can be inconsistent between people.” All agree that stress testing will remain an ongoing area of assessment and development.

**Exhibit 39: Areas incorporated into scenario planning**

<table>
<thead>
<tr>
<th>Area</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased involvement/collaboration with the businesses in identifying risks/key stresses to be captured</td>
<td>73%</td>
<td>60%</td>
</tr>
<tr>
<td>Increased the variety of scenarios to reflect the potential risk across risk types and geographies</td>
<td>69%</td>
<td>67%</td>
</tr>
<tr>
<td>Utilized reverse stress testing</td>
<td>56%</td>
<td></td>
</tr>
<tr>
<td>Increased the severity of scenarios</td>
<td>50%</td>
<td>67%</td>
</tr>
<tr>
<td>Increased the number of scenarios</td>
<td>48%</td>
<td>62%</td>
</tr>
<tr>
<td>Included operational risk events</td>
<td>48%</td>
<td>42%</td>
</tr>
</tbody>
</table>
**Exhibit 40:** More than half of the respondents need one to two months to complete a group-wide test

<table>
<thead>
<tr>
<th>Duration</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 week</td>
<td>21%</td>
<td>15%</td>
</tr>
<tr>
<td>1 month</td>
<td>29%</td>
<td>38%</td>
</tr>
<tr>
<td>2 months</td>
<td>29%</td>
<td>22%</td>
</tr>
<tr>
<td>3 months</td>
<td>13%</td>
<td>15%</td>
</tr>
<tr>
<td>4 months</td>
<td>8%</td>
<td>5%</td>
</tr>
<tr>
<td>5 months</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>6 months</td>
<td>0%</td>
<td>5%</td>
</tr>
</tbody>
</table>

Legend:
- Yellow: 2014
- Gray: 2013
Exhibit 41: Data, lack of resources remain top challenges to improving stress testing

- Difficulty in extracting and aggregating data: 60% (2014), 75% (2013)
- Shortage of resources: 48% (2014), 48% (2013)
- Difficulty in designing plausible but realistic scenarios: 42% (2014), 47% (2013)
- Inadequate systems: 42% (2014), 37% (2013)
- Time and dollar costs of regulatory compliance: 33% (2014), 15% (2013)
- Time taken to get results from business units: 25% (2014), 20% (2013)
- Inadequate methodologies: 21% (2014), 18% (2013)
Liquidity management

Regulatory complexity continues to keep liquidity high on the senior management agenda

“We are looking at everything across our liquidity management process – the systems we are building to manage the data, the models we are using, our transfer pricing rules, you name it – questioning and challenging our liquidity strategy and the liquidity plan itself.”

While there has been considerable progress post-crisis to strengthen liquidity management, the complexity of managing liquidity and meeting regulatory requirements under the Basel regime has grown significantly, and firms are making ongoing investments in people, technology and processes to comply with the intricate global and country-by-country regulations. As one executive told us, “There is a tremendous amount of work going on in liquidity management, much of which is in response to a very ambitious regulatory agenda.” As discussed earlier in this report, liquidity management is one of the top areas of focus of boards, senior management and, particularly, CROs, and many of our survey participants described major initiatives underway to strengthen the management across the enterprise.

Governance of liquidity is a joint activity throughout the organization

While the vast majority (83%) of respondents reported that their asset and liability committee is responsible for managing and monitoring liquidity risk (see Exhibit 42), it was clear from our discussions that, in an effort to achieve a more holistic view of liquidity, banks are increasingly spreading the management of liquidity across a number of areas. The risk and finance committees share responsibility in several firms interviewed, and balance sheet committees are increasingly playing a role. As one executive explained his firm’s liquidity management structure: “We have three groups managing liquidity – a chief investment officer, who is basically our ALCO’s face-to-the-street in managing the interest rate risk levels of the bank; the treasury group, responsible for managing the day-to-day liquidity of the bank; and a liquidity and balance sheet risk management group that is essentially our effective challenge to the treasury group.” While some banks are connecting liquidity to a wider management team, a few firms have created dedicated liquidity risk functions.
Shifting focus: Risk culture at the forefront of banking

Striking a balance between managing funding at a group level versus a local entity level has become a growing challenge for banks. With continuing funding and regulatory pressures, there is an ongoing shift away from managing liquidity at a group level to a more layered approach that includes both group and local entity levels. Sixty-six percent of participants are currently using this type of approach to manage funding, and 80% (up from 73% last year) are expecting to do so in the future (see Exhibit 43). There are two factors driving this shift. The first is the need to create more funding sources across a wider range of markets and currencies to reduce dependence on home currency financing, which argues for more funding at a local level. The second is that local regulation of entities has in some jurisdictions encouraged a more stand-alone liquidity focus. As a result, a number of banks are seeking longer-term financing by issuing paper in different markets, which can create some inefficiency for centrally managed banks.

Pricing structures continue to be examined and strengthened

Many firms continue to institute more stringent liquidity charging structures, both externally, with counterparties and customers, and internally, with businesses. More than half (51%) of survey respondents have made changes to their counterparty and customer charges in the past 12 months, an increase from 43% last year. These changes have primarily focused on raising charges both on lines of credit and on lines drawn (see Exhibits 44 and 45).

Several executives discussed initiatives underway in their firms to introduce more rigorous internal funds transfer pricing (FTP) approaches to more effectively allocate liquidity costs and manage incentives internally. While more than half of the survey participants said they had made changes to their FTP approach after the 2008 crisis, 43% indicated they are currently working to improve their existing approach (see Exhibit 46).
The majority of firms (89%) use the marginal cost of funding in their internal pricing analysis; 67% now include the cost of the liquidity buffer, a steady increase over the past several years; and 43% include contingent liquidity costs, an increase from 31% in last year’s report (see Exhibit 47). While 30% of survey participants indicate they continue to include historic costs in their FTP decisions, several executives interviewed reported they are moving away from utilizing historical costs in internal pricing. As one executive explained the FTP initiative, “We have just completed a big review of transfer pricing and are changing our approach from a largely historical view to a behavioral maturity view. Our ongoing challenge is to fully implement that, and to embed all the contingent calls on liquidity that could come from a rating downgrade into our product terms and conditions. We are trying to create a more realistic funds transfer framework that is reflective of the new world.”

Stress testing is considered a critical tool to manage liquidity. Over one-quarter (26%) of participants reported they are including stress funding costs in their FTP approach and are incorporating more sophisticated modeling techniques into their internal pricing process to better understand and reflect market volatility.

Firms are increasingly incorporating FTP into more and more areas of the business, including business unit pricing, strategic planning – both firmwide and for individual businesses – product design, and performance and compensation assessment for business unit leaders (see Exhibit 48). On a very positive note, 63% of participants believe there is a clear articulation of the FTP approach to the business units, a fairly substantial increase from last year’s report.
Shifting focus: Risk culture at the forefront of banking

enable control of adherence to the regulatory ratios as well as internal measures. "It's going to be a very large piece of work," he added.

Sixty-three percent of respondents listed regulatory uncertainty as their second most-challenging problem, followed by the dollar and time costs of complying with the complex regulations. Many expressed frustration with the still-evolving global and country-by-country liquidity requirements. As one executive told us, "The liquidity risk environment has become much tougher. We need to manage risk more and more on a country-by-country basis and more on a currency basis, which gives us less flexibility to flow liquidity resources throughout the world."

Uncertainty about the regulations and their ultimate impact on the industry, the complexity of managing across regions, and the organizational stresses of managing large technology initiatives are all major concerns for survey participants as they continue to strengthen and refine their liquidity management strategy and processes.

could probably spend two years arguing about the last 10%. The key is to have a set of core principles in place to drive a much faster answer."

Data quality and regulatory complexity are top challenges

The availability and quality of the data needed to comply with increasingly granular regulatory reporting requirements are an ongoing challenge for the vast majority of firms (see Exhibit 49). Quite a few executives discussed major initiatives underway in their organizations to improve data gathering and management. As one executive told us, "We have spent the last 18 months improving our data on liquidity management, moving from monthly to weekly to daily reporting to enable us to truly measure, manage and be comfortable with liquidity ratios globally and at the legal entity level." Another executive mentioned an internal initiative to integrate finance and risk data to more effectively manage both regulatory and internal liquidity requirements. As he described the process, "We are building one data center for both finance and risk management where all the data will be reconciled on a daily basis." This will enable control of adherence to the regulatory ratios as well as internal measures. "It's going to be a very large piece of work," he added.

Sixty-three percent of respondents listed regulatory uncertainty as their second most-challenging problem, followed by the dollar and time costs of complying with the complex regulations. Many expressed frustration with the still-evolving global and country-by-country liquidity requirements. As one executive told us, "The liquidity risk environment has become much tougher. We need to manage risk more and more on a country-by-country basis and more on a currency basis, which gives us less flexibility to flow liquidity resources throughout the world."

Uncertainty about the regulations and their ultimate impact on the industry, the complexity of managing across regions, and the organizational stresses of managing large technology initiatives are all major concerns for survey participants as they continue to strengthen and refine their liquidity management strategy and processes.

Exhibit 48: Firms are incorporating FTP in many areas of the business

<table>
<thead>
<tr>
<th>Business units use it in pricing</th>
<th>FTP influences business unit strategy</th>
<th>FTP influences product design</th>
<th>FTP is aligned with overall firmwide strategy</th>
<th>FTP is integrated in overall performance management and compensation calculations</th>
<th>There is clear articulation of approach to business units</th>
<th>Businesses trust that FTP costs are appropriately and fairly allocated</th>
<th>Business units view FTP rates as too volatile</th>
</tr>
</thead>
<tbody>
<tr>
<td>87%</td>
<td>85%</td>
<td>65%</td>
<td>65%</td>
<td>66%</td>
<td>63%</td>
<td>30%</td>
<td>9%</td>
</tr>
<tr>
<td>82%</td>
<td>79%</td>
<td>55%</td>
<td>61%</td>
<td></td>
<td></td>
<td>36%</td>
<td>14%</td>
</tr>
</tbody>
</table>

2014

2013
Exhibit 49: Top challenges to liquidity risk management

- Data availability/quality: 2014 - 77%, 2013 - 87%
- Regulatory uncertainty: 2014 - 63%, 2013 - 52%
- Systems architecture: 2014 - 40%, 2013 - 43%
- Definition of liquid assets: 2014 - 21%, 2013 - 18%
- Talent shortage: 2014 - 4%, 2013 - 5%
Shifting focus: Risk culture at the forefront of banking (56)
Capital management

Firms are adjusting to capital management under the new regulations.

“We are way beyond deciding whether economic capital is better than regulatory capital. You have to manage to both. It is what it is.”

The majority of firms in our study have been conducting capital management initiatives for several years – strategically reviewing priorities across geographies, legal entities and business lines and reallocating capital to reflect the much higher capital requirements under Basel III. Forty percent of survey participants have completed in-depth reviews to assess capital allocation across entities, and 65% have done so across business units. As a result of these reviews, more than two-thirds of respondents (67% this year and 80% last year) have made changes to their approach to capital across business units over the past two years (see Exhibits 50 and 51).

Exhibit 50: Many have completed in-depth reviews of capital allocation across both entities and business units.

<table>
<thead>
<tr>
<th>Status</th>
<th>Across entities</th>
<th>Across business units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Complete</td>
<td>40%</td>
<td>65%</td>
</tr>
<tr>
<td>Underway</td>
<td>22%</td>
<td>22%</td>
</tr>
<tr>
<td>Not planned</td>
<td>7%</td>
<td>7%</td>
</tr>
<tr>
<td>Planned</td>
<td>13%</td>
<td>7%</td>
</tr>
</tbody>
</table>
Basel III regulations have been finalized in both Europe and the US. The Capital Requirements Regulation and Directive (CRR/CRDIV) was finalized in Europe in July 2013, and major US banks formally started reporting their capital condition according to those requirements in the first quarter of 2014, with a fully phased-in disclosure under the new rules in effect by 2019. Although the Basel regulations are being widely implemented, they have not yet been finalized in some jurisdictions, and many banks remain uncertain about the buffers they will need to hold above the minimum requirements.

Aligning economic capital with regulatory requirements is the key driver for change

While survey results point to several important drivers of decisions to reallocate capital, the majority of respondents (62%) listed aligning internal economic capital allocation with regulatory capital requirements as the primary driver for changing their approach to capital management across business units, an increase from 55% last year (see Exhibit 52).

As we have reported over recent years, there is continuing discussion among interviewees about the pros and cons of economic capital versus regulatory capital, but the majority of executives in our study are resigned to the fact that regulatory capital is now the binding constraint from a management standpoint. As one CRO explained, “You have to measure and allocate based on the binding constraint, so as the various regulations have kicked in, the internal capital calculation has fallen by the wayside, and the brew of leverage, capital, liquidity and other things has taken over. I think our internal capital model more effectively reflects the real risk that we take as a firm, and I would like to have the flexibility to base our capital structure off that rather than the regulatory requirements, but the fact is, I can’t and we don’t.”

Despite the growing shift away from economic capital, most firms continue to maintain bank-wide economic capital models in addition to the regulatory models, and as shown in Exhibit 52, 30% of respondents (down from 45% last year) still list alignment of capital allocation to economic capital as a key driver of changes to capital management. While many agree that economic capital is no longer useful for allocating capital, many say it remains an effective risk management tool. As one executive summed up, “We are well beyond deciding which one is better. You have to manage to both economic and regulatory – it simply is what it is.”

Reallocation of capital to achieve new risk-weighted asset goals, implementation of risk appetite and re-evaluation of risks in portfolios were each listed by close to one-third of respondents as key drivers for changes to capital allocation. And while alignment of capital with internal stress testing remains at the bottom of the list, the numbers are up this year from 16% to 23%, reflecting its increasing importance as a key risk management tool.
Exhibit 52: Driver for changes in allocation of capital across business units

- **Alignment of capital allocation with regulatory capital**: 62% in 2014, 55% in 2013
- **Re-allocation of capital to achieve new risk-weighted asset goals**: 32% in 2014, 39% in 2013
- **Implementation of risk appetite**: 32% in 2014, 27% in 2013
- **Alignment of capital allocation with economic capital**: 30% in 2014, 45% in 2013
- **Re-evaluation of risks in portfolios**: 30% in 2014, 26% in 2013
- **Alignment of capital allocation with internal stress testing**: 23% in 2014, 16% in 2013
Focus on managing capital across legal entities and geographies continues

Executives report a continued focus on legal entities and geographies as they work to smooth out complexities and identify trapped capital across geographies. Eighty-three percent of survey respondents, the same percentage as last year, report greater attention to managing capital across entities and geographies in the past 12 months (see Exhibit 53). This reflects the changes in approach by many authorities to direct greater scrutiny to the level of capital and liquidity held in their particular jurisdictions over and above regulatory minimums. This trend highlights the ongoing push toward more ring-fencing of capital in local entities. As one executive asserted, “In today’s world, we need to manage the group’s capital and each entity’s aggregate requirements, as well as capital at every local level. It has become much more of a geographically focused management effort than a functional business line approach.”

Most firms have been planning for the Basel III capital requirements for several years, and most are well prepared for implementation. The uncertainty surrounding the final regulations, while still an issue in several jurisdictions, has at least diminished in Europe and the US. Managing to the new regulatory environment has, as one executive told us, “just become a standard part of doing business in the banking universe.”

Exhibit 53: Respondents continue increased focus on managing capital across legal entities and geographies

| Increased focus on managing capital across entities and geographies | 83% |
| Did not increase focus | 17% |

- 2014
- 2013
Impact of Basel III

Requirements are still driving business change

“The changes being implemented to our business models are profound. Basel III drives what is sometimes referred to around here as ‘the bank of tomorrow.’”

Basel III programs have been underway for several years for the majority of banks in our study, and many believe they are prepared for the new regulatory environment. There are still concerns around the ongoing uncertainty of some aspects of the requirements, and many continue to refine and upgrade systems and processes. But overall, the tone of our discussions was much more confident than in previous years with regard to meeting the requirements. There is now greater acceptance of the goals of Basel III: as one executive told us, “We think there are aspects of Basel III that are entirely warranted, such as the increased emphasis on high-quality capital, the greater coverage of risk types and the introduction of meaningful measures of funding and liquidity risk – we support all of those.” However, there are real concerns about the consequences for viability of business models and the disparity among regulations around the world, as well as the complexities of managing to what one executive described as “the parallel prudential regimes” across regions.

Business model refinements to adjust to Basel III continue for many firms

As we have reported over the past several years, the strategic changes that have been implemented as a consequence of Basel III have been significant for many banks, and many continue to assess and adjust their business models. As indicated in Exhibit 55, firms (83% this year) continue to conduct in-depth reviews of their portfolios to better understand the links, interdependencies and trade-offs among segments, as well as the relative costs, profitability and strategic importance of each and the consequences of retaining them. As a result of these evaluations, 43% report they are exiting lines of businesses; 38% (up from 23% last year) are streamlining legal entities. Finally, banks are still exiting geographies (11% this year, following 17% last year). The core issue is that businesses cannot attain sufficient return on the capital required, especially given the cost of the liquid
asset buffers. Legal entity restructuring is important to reduce trapping of capital and liquidity in legal entities as a result of local regulators setting their own high requirements.

For some firms, Basel III has been a catalyst to return to a more traditional focus on client relationships on both the asset and liability sides of the business. As one executive explained, “Over the years, we have become a series of competitively priced product-centered businesses, but the capital and liquidity requirements to maintain these businesses now are just too great. We are reorienting ourselves to become a client-centric bank with deep, broad-based client relationships – a ‘both sides of the balance sheet firm’ – as we were 20 years ago. It’s really a ‘back to the future’ initiative for us.”

Costs and pricing are increasing

Sixty-five percent of participants believe that the combined liquidity and capital changes under Basel III will have a significant impact on business profitability (see Exhibit 54). Banks are exploring ways to reduce costs, and several executives described initiatives in their firms to re-evaluate cost models in each of their businesses. Compensation, typically the largest percentage of total costs, is a target area for cost savings for many firms. As one executive summed it up, “In a capital markets business, 50% of your revenue is paid out in compensation.” He stressed that the only way to change costs considerably was to reduce people costs. One firm cited a move toward electronic trading, versus person-to-person interactions, as a way to improve efficiency and reduce overall compensation costs.

The pressure on profitability is driving some very difficult decisions around pricing. More respondents were clear this year about the size of increases in margin required for unsecured corporate loans. One-quarter of the firms saw the need to increase margins on unsecured corporate loans by more than 50 basis points (see Exhibit 56).

Exhibit 54: In your opinion, will the combined liquidity and capital changes under Basel III have a significant effect on the costs of doing business?

Basel III’s impact on liquidity and the balance sheet has been substantial

The introduction of the Basel III liquidity coverage ratio (LCR) in 2015 will have substantial effects on balance sheets, and many of these are already being seen. Under the LCR, banks are required to hold high-quality, low-yielding liquid assets to cover assumed stress outflows of funds. One-half of survey respondents expect that between 10% and 20% of the balance sheet will be composed of such assets, with one-third estimating more than 20% (see Exhibit 57). Fifty-eight percent report they are looking at increases in liquid asset holdings of between 25% and 100%, with over 20% expecting increases of more than 200% (see Exhibit 58). While this will help insulate the industry from liquidity pressures going forward, it reduces the portion of balance sheet available for lending. However, increasing costs and pressures to raise spreads on loans have resulted in a growing number of study participants (52%, up from 43% last year) anticipating an increase in pricing for customer deposits (see Exhibit 55) to attract more retail deposits, which will reduce the Basel III liquidity requirements. This means that banks have to be careful how the balance
sheet is constructed to reduce the liquid asset buffer as far as possible. As one executive explained, “With the Basel III rules, you have to ration every aspect of your balance sheet. You can no longer be in businesses that use too much balance sheet on your liquidity metrics.”

In addition, banks will have to increase stable funding to meet the net stable funding ratio (NSFR), which is being finalized. While almost three-quarters of firms (70% this year) believe they will be able to increase the proportion of funding to meet the NSFR requirement, there are still close to one-third (30%) of participants who do not think they can achieve a significant rise in stable funding. This has implications for the longer-term lending they will be able to do.

Exhibit 55: Firms are considering a host of changes to their business models under Basel III

- Evaluating portfolios: 83% (2014), 80% (2013)
- Increasing pricing for customer deposits: 52% (2014), 43% (2013)
- Streamlining legal entity structures: 38% (2014), 23% (2013)
- Shifting out of complex, less liquid instruments: 28% (2014), 43% (2013)
- Exiting geographies: 11% (2014), 17% (2013)

Exhibit 56: Expected effect on margins of unsecured corporate loans due to higher costs under Basel III

- Less than 50 basis points: 38% (2014), 18% (2013)
- 50 to 100 basis points: 22% (2014), 11% (2013)
- 101 to 150 basis points: 2% (2014), 7% (2013)
- 151 to 200 basis points: 2% (2014), 2% (2013)
- Uncertain: 36% (2014), 62% (2013)

Exhibit 57: Percentage of the balance sheet (under the LCR regime) that will be accounted for by the liquid assets

- 0%-10%: 16% (2014), 24% (2013)
- 10%-20%: 50% (2014), 47% (2013)
- Above 20%: 33% (2014), 29% (2013)

Exhibit 58: Percentage increase in eligible higher-quality liquid assets under Basel III relative to pre-crisis

- Less than 25%: 0% (2014), 16% (2013)
- 25%-100%: 58% (2014), 52% (2013)
- 100%-200%: 5% (2014), 23% (2013)
- 200%+: 21% (2014), 25% (2013)
Higher capital requirements are impacting ROE

As reported in the previous chapter, the increase in capital required under Basel III, together with the various national requirements, is substantial. Although almost 60% of respondents now see core equity Tier 1 increases of less than 30% from Basel III plus the global systemically important bank (G-SIB) buffer, one-third are expecting higher increases (see Exhibit 59). Banks are continuing to push down the target ROE, with about half of this year’s participants predicting returns of 10% to 15%, a decrease in expectations from last year (see Exhibit 60). This is a significant decrease from pre-crisis, when more than 70% of banks targeted ROEs of more than 15%. While many agree this is an adjustment that needs to happen, the question is how markets will react. There was considerable discussion of the reaction of investors to lower ROEs. As shown in Exhibit 61, 72% of banks reported that investors are pushing for increases in ROE. Executives are worried about how long it will take before, as one CRO put it, “the fog will begin to clear and smart investors will start to think about the opportunities versus the obstacles.” The authorities had expected that higher capital levels would lower the cost of debt and equity because of the greater safety of the banks. However, the message from the survey is that this could take years to occur.

Several made the distinction between debt and equity investors and their respective concerns. As one executive explained, “There are two classes of investors, debt investors who are increasingly wondering about the seniority of debt instruments – what will happen to them in the event a bank becomes insolvent – and then there are equity investors, who are just trying to get a read on whether a bank is adequately capitalized.” Debt investors are therefore being affected by the expected new bail-in rules whereby debt would absorb losses and prevent failure. Interviewees agreed that it would likely take some time before the ultimate impact of Basel III on investors is sorted out and the new “rules of the investor game” are determined. As another executive remarked, “Investors want to see a track record and a pattern, and until that starts to play out, there will be uncertainty about the long-term economic and return model under Basel III.”

Broad sweep of changes underway for trading books

Regulatory changes since the crisis have led to a substantial rise in capital requirements for trading books, and this is reflected in the results of this year’s survey. One-third of respondents expect an increase of between 100% and 200% in capital requirements for trading books from Basel II to the combined Basel 2.5 and Basel III. However, more respondents this year than last (35% versus only 17% last year) are seeing smaller increases of up to 50% (see Exhibit 62). This is partly due to changes in business activity or hedging that are mitigating the effects. The Basel Committee’s later proposals for trading books, following the fundamental trading book review, are widely expected to lead to further increases in requirements. For example, the Committee is proposing higher requirements for illiquid positions, more onerous model approval procedures to be applied at trading-desk level, more limited allowances for diversification, and a move to an expected shortfall rather than VaR measure for modeling capital. The Committee is currently carrying out further work to fine-tune these potential changes.
The broad sweep of changes for trading books is affecting both the capital required and the structure of the derivatives market and firm business activity in fundamental ways. Seventy-six percent of banks are undertaking business efficiency initiatives in the trading area to mitigate the effects of Basel III, including exiting activities with high requirements. More than half (51%) are moving to more advanced modeling approaches to reduce capital required. Between 30% and 40% of banks sampled are raising prices, seeking more collateral from counterparties and migrating activity to central clearing. And 18% are increasing hedging (see Exhibit 63).

Counterparty credit risk (CCR) is being actively managed. As seen in Exhibit 64, most banks are improving internal management information and the granularity of capital allocation, as well as enhancing discussion of CCR in senior committees. Following the introduction of the capital requirements directive (CRD IV) in Europe, firms are investing substantially in their systems to respond to regulatory challenges and the subsequent reduction in the scope of their model approvals. Most banks are also improving their wrong-way risk frameworks. There is a mixed picture on the approach toward hedging credit valuation adjustments (CVA – the market value of counterparty credit risk). The accounting treatment of CVA differs from the regulatory treatment – one affects the published P&L and the other affects capital requirements. Thirty-two percent of study participants hedge the accounting CVA, and 17% are putting this hedging in place. A smaller proportion of banks hedge regulatory CVA (15%), but 22% indicated they are putting that approach in place in their firms. Overall, 86% of banks are hedging CVA in some way or are establishing ways to do so.

One of the features of the new derivatives regime is the move toward central clearing of derivatives. However, the pace of change has been slower than the authorities had hoped, in part because of the number of non-standard contracts that cannot be centrally cleared, but also because of the difficulty of managing a global market with national rules. This is borne out by the survey results, which show a wide spread with regard to the percentage of derivatives likely to move to central clearing in the next 12 months. Over 50% of banks, however, expect that it will be less than 15% of the derivatives book (see Exhibit 65).

Nonetheless, the introduction of bilateral initial margin requirements for non-centrally cleared derivatives, and the anticipated impact on the liquid collateral requirement as a result, are encouraging 63% of banks to try to move more contracts to central clearing, 46% to reduce activity in OTC markets, and 66% to change pricing of OTC derivatives (see Exhibit 66).
Exhibit 63: Majority of banks undertaking capital efficiency initiatives to mitigate effects of Basel III requirements

- Undertake capital efficiency initiatives: 76% (2014) vs. 64% (2013)
- Move to advanced approaches: 51% (2014) vs. 49% (2013)
- Migrate more activity to central clearing: 40% (2014) vs. 47% (2013)
- Seek more collateral from counterparties: 36% (2014) vs. 40% (2013)
- Increase price: 33% (2014) vs. 34% (2013)
- Increase hedging: 18% (2014) vs. 15% (2013)
- Reduce firm’s activity in derivative markets: 7% (2014) vs. 8% (2013)

Exhibit 64: Banks actively planning enhancements for CCR management

- Improve granularity of capital allocation and management: 60% (2014) vs. 21% (2013) vs. 19% (2013)
- Enhance discussion of CCR in senior committees: 57% (2014) vs. 11% (2013) vs. 32% (2013)
- Improve internal management information (MI): 70% (2014) vs. 9% (2013) vs. 21% (2013)
- Improve wrong-way risk framework: 57% (2014) vs. 29% (2013) vs. 14% (2013)
- Active hedging of regulatory CVA: 22% (2014) vs. 63% (2013) vs. 15% (2013)
- Active hedging of accounting CVA: 17% (2014) vs. 51% (2013) vs. 32% (2013)
- Alignment of CCR and accounting CVA exposure calculations methodologies: 40% (2014) vs. 30% (2013) vs. 30% (2013)
- Alignment of CCR and market risk IT infrastructures: 50% (2014) vs. 33% (2013) vs. 17% (2013)
2014 Risk management survey of major financial institutions

Top challenges of Basel III implementation

As we have discussed over the last few years, firms have been actively addressing the multiple challenges involved in the implementation of the Basel III regulations. Data and systems continue to top the list as key challenges to regulatory compliance and, as we have reported, firms have undertaken major initiatives to upgrade their data and systems capabilities (see Exhibit 68). Managing intraday liquidity and continued uncertainty around the definitions of liquid assets are high on the list of challenges for many participants.

Close to half of the respondents (49%) are concerned about the impact of managing the multiple and inconsistent regulatory requirements around the world. As one executive explained, “The Basel III capital and liquidity reforms are actually quite sensible; it’s how individual regulators have chosen to cherry-pick pieces of them to enforce that is the challenge – the disparity is a frustrating problem.” Of particular concern this year is the possibility that efforts to standardize risk-weightings will make capital requirements less risk-sensitive. Basel II-modeled approaches are under review, and there is pressure from some countries for simpler broad-brush requirements. There is some concern that the leverage ratio, which is not risk-sensitive, might become the binding constraint. One executive expressed his opinion on the issue: “Outside the specifics of Basel III, there’s a parallel prudential regime debating whether risk-weighted assets can be trusted, and this is creating significant uncertainty around capital requirements. We think this is very dangerous. Our view is that risk-weighted assets, by their very nature, are a measure of risk, and simplifying it, taking away the risk measurements, is quite perverse.”

Another executive concurred: “The consequences of going back to standardized models are very dangerous. That lack of granularity is what got us into the first crisis. Basel II and Basel III have seen a significant investment in risk management processes and systems – why would we turn around now and de-emphasize the importance of risk management?”

Exhibit 65: Banks moving slowly to central clearing of derivatives

| 0%-5% | 25% |
| 5%-15% | 27% |
| 15%-25% | 16% |
| 25%-50% | 16% |
| 50%-75% | 14% |
| 75%-100% | 2% |

Exhibit 66: Introduction of margin requirements resulting in business model changes

| Change pricing of OTC | 66% |
| More contracts to clearing | 63% |
| Reduce activity in OTC | 46% |

Exhibit 67: Main drivers of changes to derivatives business models

| Return on capital/Basel III | 75% |
| Dodd-Frank/EMIR | 65% |
| Risk/return | 45% |
| Forthcoming regulation on margin requirements/non-IMM approaches | 20% |
| Demand | 15% |

There is widespread change in the overall derivatives business model, with 42% of this year’s participants indicating they are rethinking their approach. Seventy-five percent of respondents reported that Basel III has had an effect on capital returns, and Dodd-Frank in the US, together with European Market Infrastructure Regulation (EMIR) and other structural reforms in Europe, are driving business model changes in 65% of banks (see Exhibit 67).
This message was echoed by others as well. The crisis occurred “on the watch” of Basel I, which had very simple requirements (8% for most exposures to the private sector except mortgages), drove regulatory arbitrage and contributed to the crisis. Basel II, introduced in 2008 for the major banks (although not in the US), brought in requirements that resulted in increasing the risk spectrum, driving capital higher for higher risk exposures and also improving management information in the banks.

In summary, the changes that have been, and continue to be, initiated under Basel III have been significant for many banks. While many believe they are prepared for the initial round of Basel III implementation, the complexity and uncertainties of the global regulatory environment and its ultimate strategic impact on the industry remain a challenge.
Recovery and resolution planning

Despite challenges of regulatory clarity and cohesion, recovery and resolution planning is well underway for banks around the globe.

“...When I hear my staff complain about the RRP process, I tell them how lucky they are to be participating in a process that touches on everything we do. There’s no better way to learn about the intricacies of this institution.”

Bank recovery and resolution planning (RRP) continues to be a challenging process for many banks, particularly for large global institutions that must comply with the many diverse and still-evolving regulatory requirements across jurisdictions. While regulators in dozens of countries have requested formal or informal plans, there are still many geographies where recovery and resolution planning has not yet been mandated, or where banks are still in preliminary discussions. The sharpest focus has been in the G20, where countries required that their G-SIBs submit initial plans by the end of 2012. In countries without G-SIBs, institutions are required to begin collecting the information in preparation for submitting their plans. Resolvability assessments and actions to increase resolvability were expected to continue beyond 2013. In practice, while recovery plans are embedded at most G-SIBs, resolution planning continues.

Recovery plans have been developed much further than resolution plans in most countries. This reflects both the regulatory requirements and executive belief that there is more value in creating a recovery plan than a resolution plan. Seventy-seven percent of all survey respondents reported they have completed final recovery plans that outline how the firm will use a series of predetermined options to avoid failure (Exhibit 69). This is a significant increase from last year’s study, in which 49% reported they had completed their plans. All the survey participants in North America and 88% of respondents in Europe have completed their plans. Only one firm in this year’s survey indicated that it did not expect to produce a plan.

Resolution plans, on the other hand, require firms to submit information and data to the authorities so that they can determine how best to wind down the firm in case of its failure and/or ensure the continuity of its critical functions. Thirty percent of respondents indicated they have completed a final resolution plan (up from 10% last year), 12% have completed a preliminary plan and 24% have provided material to the authorities to enable them to produce a plan.
Shifting focus: Risk culture at the forefront of banking

Six percent are not planning to develop a resolution plan at this time (see Exhibit 70). These numbers partially reflect that in some jurisdictions, banks are required to submit information to authorities who then produce the plan. In general, G-SIFIs are much further along in developing resolution plans than are smaller institutions, with many having submitted plans in multiple jurisdictions. Other geographical variables reflect the differing speeds at which regulators are requiring that plans be submitted.

While executives who submitted resolution plans say they have made progress, they remain skeptical of the bottom-line effectiveness of the resolution process, particularly for large cross-border institutions that will require governments and regulators to work closely together to resolve a failure. As one executive explained, “We have submitted what we think are very good plans that are as effective as they can realistically be in the present environment. However, there are
outstanding open issues, including how different governments and regulators would work together to resolve large financial institutions with significant cross-border businesses. As long as there are uncertainties in answering that question, we’re never going to have something that you could put hand on heart and say is assured of being effective.” Another added, “There’s a saying about ‘global in life, local in death’ – if it comes to resolution, individual countries won’t look at the big picture.”

Some banks, however, are finding value in the resolution exercise. As one executive noted, “Our stakeholders are pleased and reassured that, in a worst-case scenario, we have a framework and process in place to manage the resolution of the bank.”

While the bulk of planning is taking place in Europe and North America, executives in other parts of the world said they expect similar requirements at some point. As one executive in Asia said, “There is currently no regulatory pressure for us to look at this, but, given what we know is happening in the more developed markets, we are looking at what we need to do from a recovery position and resolution point of view.”

**A major commitment of time and resources**

While 26% of the firms that have completed recovery plans reported the process took less than six months, close to half (46%) spent up to a year and more than a quarter between one and two years to complete their plans (see Exhibit 71). For those that have completed resolution plans, 29% took less than six months and 57% took up to a year to complete the process (see Exhibit 72).

Regardless of the time commitment, there was uniform agreement that the RRP process is arduous and, even for those who have completed plans, an ongoing effort. According to several executives, regulators have made it clear that the RRP process will be “continuous,” and plans in some jurisdictions must be renewed annually. Executives said the most time-consuming part of the process is coming to agreement with the regulators about the level of detail needed in the plan. As one CRO noted, “For us, it’s a 1,500-page document – it’s just a massive amount of data that is burdensome to maintain.”

**Exhibit 71: Time to complete recovery plan**

<table>
<thead>
<tr>
<th>Time to Complete</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 months</td>
<td>26%</td>
<td>20%</td>
</tr>
<tr>
<td>6 months to 1 year</td>
<td>46%</td>
<td>50%</td>
</tr>
<tr>
<td>1 to 2 years</td>
<td>29%</td>
<td>23%</td>
</tr>
<tr>
<td>More than 2 years</td>
<td>7%</td>
<td>0%</td>
</tr>
</tbody>
</table>

**Exhibit 72: Time to complete resolution plan**

<table>
<thead>
<tr>
<th>Time to Complete</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 months</td>
<td>29%</td>
<td>18%</td>
</tr>
<tr>
<td>6 months to 1 year</td>
<td>57%</td>
<td>36%</td>
</tr>
<tr>
<td>1 to 2 years</td>
<td>7%</td>
<td>36%</td>
</tr>
<tr>
<td>More than 2 years</td>
<td>7%</td>
<td>10%</td>
</tr>
</tbody>
</table>
Shifting focus: Risk culture at the forefront of banking

Making RRP meaningful

Having devoted the time and effort to developing plans, banks are working to translate the results of the process into meaningful implications and actions for their organizations rather than simply compliance with regulators.

Executives agreed that their boards and senior leaders are making efforts to connect RRP to bank processes. While the majority (71%) report no major changes as a result of the RRP planning, 24% report they have simplified the group structure (up from 7% last year), and 18% report a change in other intra-group services (see Exhibit 74). As one European executive explained, “We think that the implications of recovery and resolution will certainly be integrated into the procedure and decision-making systems of the bank, but we do not plan to change the structure of the bank.” Another executive concurred: “I think it’s becoming more a story of actually implementing some of the structural reforms that are required. If we think of Dodd-Frank Section 165 or retail ring-fencing in the UK, it’s more about getting on with detailed planning and implementation of those.”

Several interviewees discussed specific ongoing improvements in processes as a result of RRP, including enhanced stress testing and enhanced monitoring, reporting and triggering processes. As one executive described their effort, “We have embedded more of the recovery plan processes into our weekly reporting and have synchronized our recovery plan dashboard with our ALCO reporting and risk appetite statements.”

While several executives agree that RRP planning works best when it is the joint responsibility of both the CRO and the CFO, nearly two-thirds of respondents (70%) reported that the risk team leads the RRP planning process, and 48% reported that the finance department drives planning (see Exhibit 73). These figures closely mirror the results from last year’s study, indicating that the planning structure has been put in place for most organizations and is unlikely to change from year to year. One bank in our study has created a separate team responsible for developing the resolution plan that, according to the executive of the bank, “provided the regulatory supervisor a resolution plan which is quite precise, quite detailed.”

Exhibit 73: Area of business leading recovery and resolution planning

<table>
<thead>
<tr>
<th>Area</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk</td>
<td>70%</td>
<td>60%</td>
</tr>
<tr>
<td>Finance</td>
<td>48%</td>
<td>35%</td>
</tr>
<tr>
<td>Operations</td>
<td>6%</td>
<td>12%</td>
</tr>
<tr>
<td>Compliance</td>
<td>6%</td>
<td>2%</td>
</tr>
</tbody>
</table>

Exhibit 74: Are changes likely as a result of recovery and resolution planning?

<table>
<thead>
<tr>
<th>Change</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>No changes are being made</td>
<td>71%</td>
<td>80%</td>
</tr>
<tr>
<td>Simplification of the group structure</td>
<td>24%</td>
<td>7%</td>
</tr>
<tr>
<td>Change in other intra-group services</td>
<td>18%</td>
<td>0%</td>
</tr>
<tr>
<td>Change in the business model</td>
<td>6%</td>
<td>2%</td>
</tr>
</tbody>
</table>
Unclear regulatory expectations lead RRP challenges

Understanding the varied regulatory expectations around the world, especially for resolution planning, is increasingly posing major challenges to banks. Seventy-five percent of respondents listed understanding regulatory resolution expectations (up from 56% in 2013), and 66% cited cross-border expectations surrounding resolution plans (up from 45% last year), as their most pressing challenges (see Exhibit 75). Different approaches to RRP planning across jurisdictions, the impact of varying ring-fencing proposals, and the lack of collaboration and cooperation among regulators were repeatedly mentioned as significant challenges for executives interviewed.

Mapping linkages across the organization was listed as another challenge, particularly for resolution planning purposes. And many also discussed the time and expense to create the systems to find and retrieve the immense amount of data needed to comply with regulatory requirements.

RRP continues to raise challenging questions for firms, including the degree to which they will have to change their business activities and their legal and operational structures, the timing and investments needed to adapt, and the way to make the plans usable in a tight time frame. However, despite the many challenges, the industry is coming to accept recovery and resolution planning as both a necessary and valuable facet of risk management.
Exhibit 75: Top challenges of recovery/resolution planning

- Understanding regulatory expectations: 55% (75%)
- Cross-border regulatory expectations/timelines: 45% (66%)
- Mapping linkages across the organization: 36% (53%)
- Finding the right data: 29% (50%)
- Cultural barriers to contemplating failure: 12% (13%)

Categories:
- Recovery planning
- Resolution planning
Internal transparency, data and systems

Data aggregation and risk reporting remain areas of focus

“Having the data is obviously not nearly enough for successful risk management, but it’s clearly a minimum standard. It’s very hard to manage risk if you can’t even measure it.”

Throughout our discussions with bank executives, internal transparency of information and the data and systems to enable that transparency in a timely manner have been cited as critical components for successful risk management. Whether establishing a strong culture, embedding a risk appetite or effectively managing liquidity and capital, senior management needs timely, accurate data and holistic reports aggregated across businesses and geographies to make appropriate decisions and monitor results. Particularly in today’s dynamic regulatory and economic environment, visibility and access to the right information across the organization have become a strategic imperative.

Improving internal transparency continues to be an ongoing initiative for most study participants. Since the Basel Committee issued Principles for Effective Risk Data Aggregation and Risk Reporting in January 2013, the bar for banks has become significantly higher. G-SIBs have to implement the principles by January 2016 and are expected to demonstrate annual progress toward this goal. In addition, the FSB and the Basel Committee have requested that national supervisors monitor progress during the implementation period, and it is anticipated that the principles will likely be applied to the domestic SIBs (D-SIBs) in a number of jurisdictions.

While many executives reported significant progress in improving transparency over the past several years, most interviewees acknowledged that systemically improving transparency is an enormous, multiyear journey requiring a considerable investment of management time and resources. As one executive described it, “Improvements are currently underway, have been for some time and always will be.” Another described the “costly and enormous projects” being undertaken in this area.
Firms are rebalancing the use of economic capital models

Given the performance of economic capital models in the run-up to the crisis, the surveys across a number of years have shown that firms are increasingly balancing economic capital with the use of other metrics. This trend continued this year – 63% (versus 49% last year) indicate that, while still important, economic capital is being balanced by other metrics (see Exhibit 76). Over half (59%) of survey respondents report that they are not currently investing in redevelopment of economic capital models, most likely because they have already made changes in earlier post-crisis years or because of the de-emphasis of economic capital’s importance in the industry. The economic capital models in place pre-crisis often under-read risks, and a number of firms are continuing to repair the deficiencies in their economic capital models with the introduction of a wider set of risks. Twenty-six percent are adding risks not in VaR (up from 10% last year), 21% are reducing diversification benefits (up from 15% last year), and 18% are adding illiquidity of trading positions (up from 8% last year) (see Exhibit 77).

Executives reported progress on risk transparency in several key areas, as noted in Exhibit 78. Stress testing, counterparty risk and risks not in VaR remain strong areas of improvement this year, as they were last year, while stress VaR, illiquidity and measurement uncertainty have declined as areas of improvement.

While there was much discussion around activities underway to improve risk transparency, most initiatives focused on three key areas:

1. Improving data aggregation, accuracy and quality
2. Streamlining reporting
3. Investing in systems

Improving data aggregation, accuracy and quality is an ongoing initiative

As in previous years, data and systems vied for the top spot on the challenges to internal transparency (see Exhibit 79). Interviewees cited many initiatives underway to improve data management and infrastructure, and many firms are reviewing and revising the full life cycle of risk information to improve underlying data quality, including governance, data acquisition, analytics and reporting infrastructure. As one executive said, “For us it’s all around improving data quality – understanding our needs in terms of data, being able to then identify where those data sources are and looking at improving our data warehousing capability.”

Respondents were asked a series of questions about the capabilities of their risk data governance, systems and processes. As can be seen in Exhibit 80, there are several areas where firms indicate they are doing well. More than half (58%) report they have an explicit governance structure for risk data that covers roles and responsibilities. An even higher number (77%) say that this structure brings together senior-level business line, unit and IT personnel to cover the end-to-end
2014 Risk management survey of major financial institutions

Better data governance right down through the organization, formulating roles of data stewards and making sure that we have proper tools throughout the bank. We need to have much stronger confidence in the quality and timeliness of the data so that we can aggregate our exposures in the event of a crisis.”

Data aggregation across multiple legacy systems continues to be challenging for many institutions. As one executive commented, “We are spending a gazillion dollars on a silver bullet to integrate different systems that don’t correlate.”

Many agree that the key to good aggregation is breaking down data silos, centralizing databases and developing a common taxonomy. Several described significant advancements in consolidating data across their organizations. One executive underscored their importance, noting “We’re very focused this year on driving risk policies for standards and better data governance right down through the organization, formalizing the roles of data stewards and making sure that we have proper tools throughout the bank. We need to have a much stronger confidence in the quality and timeliness of the data so that we can aggregate our exposures in the event of a crisis.”

However, responses indicate there are several areas that still need to be strengthened. Less than half (40%) say they have a comprehensive documented inventory of risk data limitations with respect to reporting and data aggregation. Less than 20% are confident they have robust data metrics and measurements in place to clearly identify potential risk issues. And only 6% say they can provide sufficiently comprehensive firmwide risk reports that can generate specific views on their risk profile on an intraday basis, even in a crisis situation. One executive underscored their importance, noting “We’re very focused this year on driving risk policies for standards and...”

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Shifting focus: Risk culture at the forefront of banking

Business lines continue to be an area that needs attention. Fifty-six percent of survey respondents say they can aggregate counterparty exposure across business lines by the end of the day, roughly the same number as a year ago. Twenty-four percent say it takes up to two days, and 20% report it taking more than two days. Seventy-three percent of respondents have an automated process for counterparty risk aggregation, a similar result to last year.

However, while data consolidation is progressing, many agree they are still challenged by the quality of the data and the ability to assess the correlation effects on an integrated basis.

Exhibit 78: Changes in the past 12 months to enhance internal risk transparency

<table>
<thead>
<tr>
<th>Risk Category</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stress testing</td>
<td>77%</td>
<td>79%</td>
</tr>
<tr>
<td>Counterparty risk</td>
<td>46%</td>
<td>47%</td>
</tr>
<tr>
<td>Risks not in VaR</td>
<td>38%</td>
<td>39%</td>
</tr>
<tr>
<td>Stress VaR</td>
<td>27%</td>
<td>53%</td>
</tr>
<tr>
<td>Illiquidity</td>
<td>25%</td>
<td>37%</td>
</tr>
<tr>
<td>Tail VaR</td>
<td>17%</td>
<td>19%</td>
</tr>
<tr>
<td>Valuation uncertainty</td>
<td>15%</td>
<td>19%</td>
</tr>
<tr>
<td>Notional or gross positions</td>
<td>13%</td>
<td>14%</td>
</tr>
<tr>
<td>No enhancements to internal transparency</td>
<td>13%</td>
<td>11%</td>
</tr>
<tr>
<td>Measurement uncertainty</td>
<td>6%</td>
<td>12%</td>
</tr>
</tbody>
</table>

legal entities that are connected to a central data warehouse. The executive explained the benefits: “We have automated feeds in our central database and do not need separate aggregated data deliveries from each entity. We can check data quality at a very early stage and correct it early and make the data available for reporting.” Several banks reported they have been working to consolidate their risk and finance databases, which, as one interviewee told us, is “undoubtedly an issue and a huge effort for many banks.”

Many firms, at considerable cost, have been working for some time toward end-of-day mark-to-market for trading portfolios, but the ability to aggregate counterparty exposure across business lines continues to be an area that needs attention.
Many are working to streamline reporting

There are increasing demands, both from boards and from regulators, for reliable and timely reporting in a clear format. The theme of streamlining reports tailored for specific constituents ran throughout our discussions with executives, and many are experimenting with different forms of reporting in response to changing board needs. As one CRO related, “We have come to the conclusion that we have probably over-cooked the detail that’s gone into our reports. We have gone through a process just this last quarter to focus on the issues that we should really be talking about and debating. We are working to reduce the massive amounts of paper, metrics and tables in our reports and encouraging longer discussions with higher-quality input from the people around the table.” Another interviewee described the effort to simplify and clarify reports: “We are getting better at reporting in an easily digestible format, using dashboards to highlight the state of play in terms of our risk – what are the early warning signals, what new risks do we see around the corner.”

While the reporting process is much improved in many organizations, problems persist. Among them are data quality, gaps in connectivity from system to system and masses of data presented with little analysis. Executives looking beyond data aggregation said that reviewing, analyzing and interpreting the reports to make them relevant and to understand dependencies and correlations is a crucial next step.

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Exhibit 79: Top challenges to internal risk transparency

Exhibit 80: Risk data coverage capabilities vary
Investment in systems continues

As we have been reporting over the years, there has been significant investment in IT upgrades since the crisis, and there is no abatement in sight. Seventy-five percent of survey respondents report an increased IT spend in the past year, an uptick from 63% in last year’s report (see Exhibit 81). Thirty-two percent of the banks reporting an increase in spending over the past 12 months indicate this increase ranged between 1% and 10%; 24% report an increase in spend between 11% and 20%; and interestingly, 29% indicate their IT spend increased between 21% and 30% (see Exhibit 82). Sixty-five percent expect to increase spending on IT over the next two years, while 29% reported no anticipated change – an increase from 8% last year (see Exhibit 83).

Interviewees reported a number of ongoing projects to support risk architecture, including data aggregation and convergence of risk and financial data, improving data quality and integrity, strengthening stress testing processes, and projects in support of liquidity and capital management. Risk is increasingly working with finance and treasury on integrated systems, an important breakdown of silos within organizations. As one risk executive explained, “We are increasingly working closely with finance and, more specifically, with treasury and capital management. Risk management, finance and, specifically, the IT wing within finance, are already co-dependent on data, so system integration is something we have to get right.”

As banks continue to prepare for and implement the Basel III principles, the emphasis on infrastructure and reporting will undoubtedly continue to grow. Executives noted that these efforts take tremendous management time, money and resources, but they also acknowledged that getting past the limitations of legacy systems will allow their organizations to run more efficiently over the long term and will facilitate risk management across the enterprise.
Conclusion

The theme of this year’s survey is risk culture and conduct. Although progress has been made on many fronts since the crisis, with enhancements to both the role of the board and risk function and improvements in techniques like stress testing, banks now see that without the appropriate culture, harmful behavior and decisions can undermine the firm through reputation damage. The regulators have this firmly in their sights, and a number of papers on the issue are being released by the FSB and national regulators.

The survey highlights the number of areas that need to come together to effect change, starting with risk management and an embedded risk appetite and covering areas like incentives, the accountability of the front office and a clear statement of values from the top. This is also a theme in Risk Culture and Effective Risk Governance (September 2014), a book edited by EY’s Head of Risk Governance and Financial Regulation, Patricia Jackson, which includes chapters written by global regulators and leading practitioners in fields such as banking, consulting and academia.

With conduct and compliance driving much of the current concern about culture, the industry is also moving to change the way these are treated. The current rules-based, legal-driven approach is being enhanced in some banks by assessments of intrinsic risk and development of scoring to determine whether risks are rising. In a number of banks, the risk function is also becoming more involved in non-financial risks. This is also driving modifications in operational risk measurement, resulting in more granular assessment of different risk types.

In many other areas, the survey highlights the time and effort needed to develop new risk approaches and ingrain them into the enterprise. Risk appetite needs to be embedded in business decisions, but many banks still have far to go, even with the traditional credit and market risks, let alone non-financial ones. Improvements in stress testing have occurred year by year, but again, more effort is needed to make it a flexible management tool actively influencing decisions. And data and systems remain areas that hamper effective change despite substantial increases in investment.

At the same time, the industry is trying to deal with a seismic shift in business models caused by the reluctance of investors to accept the lower ROEs resulting from Basel III. With the massive change agendas and continuing new concerns being raised by regulators, it is not surprising that the survey highlights the degree to which boards, risk functions and senior management feel stretched paper-thin.
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