SUERF

Two Ends of the Spectrum - the Challenges of Risk Management and Effective Resolution

Report on a SUERF/EY Conference in London on Thursday 13 March, 2014

By Patricia Jackson, EY LLP UK and SUERF
and Morten Balling, Aarhus University, Denmark

(l-r): Andy Baldwin (EY), Patricia Jackson (EY & SUERF), Mark Carey (Federal Reserve System) & Adam Farkas (EBA)

In his welcome speech, **Andy Baldwin**, EMEIA Financial Services leader at EY, reflected on the pressure the financial services industry is under from the pace of regulatory change. Since 2008, there have been more than 10,000 regulatory changes with implications for the financial industry, and not all have been globally consistent. Andy welcomed all the efforts by EBA, PRA and others to bring about more cross-border consistency in regulation, but voiced concerns that 'Balkanization' in Europe could undermine the benefits of a single European banking market. He stressed that banks should of course be required to have a sensible level of capital - 'we all want a safer financial system' - but highlighted that punitive regulation and regulatory uncertainty are undesirable and can negatively impact economic growth. To cope with the challenges of such a strongly regulated and fast-changing financial market, Andy raised the importance of bringing the best brains together across industry, policy and academia and welcomed the chance that the conference gave to do this. He also raised some important questions for the audience to consider: looking forward six months to after 1 November 2014, how will the ECB's regulation and supervision function? And will the next five years see a similar level of regulatory change as we've seen in the five years since the crisis?

Patricia Jackson, EY LLP UK and SUERF, chaired session 1 on *Risk Governance*. She gave an overview of the focus of the authorities. The first aim after the crisis had been to increase capacity to absorb losses (with higher capital and liquidity) but there needed to be a shift in focus. The authorities cannot go on putting more and more weight on increasing resilience. Ways of reducing the likelihood of losses ex ante had to be a priority. The FSB papers on risk governance and the attention being paid to stress testing by the authorities were therefore very important. However, more coordination was needed by authorities with regard to the officially mandated stress tests in terms of data required, approach etc. Turning to the question of risk governance in the industry an EY/IIF Survey from 2013 had highlighted a range of areas which were still providing a challenge. Risk appetite had been changed by many firms but embedding it down through the organization and using it to constrain business decisions was still proving difficult for example. She said that the current year's survey was producing similar messages. Risk culture was a key area of focus and needed attention from both boards and the authorities. Risk culture must be pro-active. If there are breaches of controls there must be seen to be consequences. In order to improve risk governance, it was essential to affect risk culture and conduct. There had be a failure in the three lines of defence model in that the risk function had ended up owning the risk profile. Going forward, front office employees needed to responsible for all the risks including operational risk and reputation from their activities. Also conduct risk must be treated as a risk type to enable a focus on the forward risk.

Mark Carey, Board of Governors of the Federal Reserve System, gave the presentation: *"The importance of risk transparency and stress testing."* Risk transparency is important, but full transparency is nearly impossible to achieve because banks must preserve the confidentiality

of their books and strategies and because different outsiders are interested in different elements of a bank's risk posture. A firm's internal stress tests are very useful management tools, but are of limited use in promoting risk transparency, in part because each outsider is likely to want results of a somewhat different stress test, and in part because firms vary in their ability to conduct a true firm-wide stress test that incorporates strategic reactions to the stress. The stress tests done by major banks in the U.S. at the behest of regulators aid transparency, but serve a variety of other purposes as well. The primary benefits of the initial tests done in 2009 (the SCAP) were restoration of confidence in major banks and in regulators. SCAP also set process improvements in motion at banks. As time has passed and the industry has recovered, certification effects have become less important relative to other benefits, among which are aiding discipline of internal failure of risk measurement and management and improving the effectiveness of the supervisory process. One way in which a firm can receive an "objection" to its CCAR submission and capital plan is by having inadequate internal risk measurement and modelling procedures. The publicity surrounding an objection tends to motivate firms to improve. CCAR aids the supervisory process because great effort is expended to thoroughly examine banks' CCAR submissions and processes and to rank their quality. This helps ensure that different supervisory teams are paying attention to an array of possible issues. Because Europe is in the process of developing its single supervisory mechanism, it would be appropriate for its stress tests to differ somewhat from those done in the U.S., and for them to change and develop in future years to suit European needs.

Adam Farkas, Executive Director, European Banking Authority (EBA) gave *"An overview of the 2014 EU-wide stress test"*. He started by setting the context. The EBA is a small organization with limited resources and with a mandate to "initiate and coordinate" the European stress test which affects the way that stress testing has to be done. The overall aim of this work is to strengthen the EU banking sector. Since 2011, banks have been pushed to improve their capital positions and the 2011 stress test led to Euro 50bn being raised in capital ahead of the test, which was followed by an additional 150bn in response to the 2011 recapitalisation recommendation. EBA wanted to reduce the incentives for banks to de leverage. They were encouraged to increase capital not cut lending. The 2014 stress testing exercise is very important for the Single Supervisory Mechanism (SSM). EBA is not a direct supervisory institution. EBA has, however, the responsibility for coordinating EU-wide stress tests that can be used by ECB and the national supervisory authorities. EBA is responsible for common methodology, scenarios, templates, a data hub and common EU benchmarks. The aim is to ensure consistency and comparability across borders and banks. Common exercises should facilitate the creation of benchmarks that can be used to analyse the impact on EU-banks under common adverse market conditions. The exercise should provide a rigorous assessment of banks' resilience. At least 50 % of the national banking sectors in each EU member state should be included in the test exercise. Data from banks in the sample will be exposed to consistent macroeconomic scenarios and market risk shocks. EBA uses a static balance sheet assumption (zero growth) for both the baseline scenario and the adverse scenario. Credit risks cover all counterparties incl. firms, institutions and sovereigns. Market risk covers all positions exposed to changes in market prices. More details about the stress testing methodology can be found on EBA's website. The speaker concluded by listing some open issues: The interaction of asset quality reviews (AQRs) and stress tests. The timing of communication by EBA respectively the national supervisory authorities of testing results. A common approach to prudential filters for sovereign risk. In May 2014, more details on methods will be disclosed. Subsidiaries of oversees banks will not be included although competent authorities may choose to look at them.

These presentations were followed by a panel discussion on embedding risk appetite, achieving accountability, enhancing stress testing, data and systems challenges.

Sylvie Matherat, Banque de France, stressed the need to improve the incentives to banks to better risk governance. Constraints on leverage, solvency and liquidity represent the framework for risk-taking, but it is important to embed in the organisation the risk appetite of bank managers. Risk officers should possess better internal knowledge of the risk profile of the bank's own assets. There should be more transparency about internal models. The use of Basel pillar 3 should be enhanced. Risk management practices and the results of stress tests should be disclosed. Both markets and banks should be educated in risk management and communication. Publication of the results of stress tests could be an alternative or a supplement to ratings.

Sylvie Matherat & Richard Herring

Colin Church, Citibank, described the magnitude and pace of the infrastructure changes in banks driven by the current regulatory agenda and highlighted the importance of potentially implementing a consistent data hierarchy solution to cross border stress testing and resolution processes. A fragmented approach to these issues could potentially delay implementation, be harder to maintain, preclude systemic cross border aggregation of risks and dilute an opportunity to enhance the credibility of these measures and processes with a common global standard. During the crisis market confidence was not enhanced by the global inconsistencies in regulatory capital measures and practices, which arguably led to the need for the further important clarity provided by national and regional stress tests. There now appears a unique historical opportunity to align the frameworks and underlying data structures of current stress testing initiatives which if missed may not present itself again. Additionally, there are also a number of "model portfolio" type current private and public sector initiatives targeted at delivering a ex post calibration of bank provided risk measures to provide needed perspective on how specific banks risk and reserving measures relate to one another. These initiatives could ultimately provide a very important compliment to international capital and stress testing frameworks, by providing greater insight and credibility to these measures as well as ultimately progressing the market discipline hoped for in further development of Pillar 3 disclosure.

Keiran Foad, Santander, also discussed how to embed risk appetite throughout the organization. Do people really understand their exposures? In a survey on risk management conducted by EY in conjunction with IIF, a majority of the respondents referred to implementation of risk appetite as a main challenge. Such implementation requires answers to the questions: How? Where? When? Why? Who? and What? Answers must be linked with business models, strategy setting and capital- and liquidity planning. Risk appetite must be allocated to risk types and across different business areas. It must be part of the corporate culture. People should be incentivized. Finally it came down to a question of risk culture in the front office and incentives aligned across the firm. The following discussion covered issues like the need for inclusion of risk measures in accounting and reporting, the need for standardized stress tests, burden sharing in resolution situations and the interaction between resolution policies and other public policy areas.

Richard Herring, Wharton School, University of Pennsylvania, gave a presentation: *"Incentives to improve corporate risk governance in financial institutions"*. There is a lot of evidence of weak risk governance in the financial sector and a strong need to improve market discipline. If this discipline is going to work, markets must understand the corporate structure and the presumptive path of the allocation of losses. Waves of recommendations concerning improved risk governance have been published and core principles on governance have been formulated. According to empirical studies, however, corporate governance principles do rarely lead to better outcomes. Bad remuneration practices have distorted the incentive structure of bank managers. It is clear that attitudes toward compensation differ across the Atlantic. Due to weak performance during the financial crisis, regulatory authorities suffer from a credibility gap. Regulation is not effective. The speaker showed a cartoon, in which a bank manager talks with his lawyer. The text was: "These new regulations will fundamentally change the way we get around them". In most banks, the internal risk management procedures have underestimated the required equity in relation to the risk. Banks have also relied on rating agencies, whose ratings in some cases were misleading because they were influenced by distorted incentives. If risks are not measured properly, they cannot be managed properly. The central challenge is how to change incentives to enhance corporate governance of risk. Increased capital requirements are unlikely to be sufficient to improve risk governance. The appropriate financial instruments are contingent convertible bonds (CoCos). When the so-called trigger-event happens, the bonds are converted to shares and the bank's loss absorption capacity increases. Properly designed CoCos can help resolve uncertainty. Bank managers get an incentive to issue equity pre-emptively. Since book values can be manipulated, the speaker preferred the stock price of the bank in the market or a quasi-market value as trigger. A threat of dilution will focus managerial attention on improved risk

and management. Conversion should be a CEO's nightmare. A study of how US GSIBs would have performed during the recent crisis if they had issued CoCos with a 90 day rolling quasi market value as trigger, shows that this modified capital structure would have distinguished 4 American financial institutions that managed to come through the crisis without major subsidies from 10 that did not, as they failed, were forced into merger or received major SCAP infusions. CoCos would have provided time to enable some GSIBs to restructure and recapitalize and would also have alerted supervisors to looming problems.

In the following discussion, a main theme was the attitude of investors to CoCos and the prices in the market of these securities.

Session 2 on *Resolution Challenges* was chaired by **Thomas F. Huertas**, EY LLP UK. In his opening remarks and in the paper circulated to conference participants, he stressed the importance of making banks resolvable, or "safe to fail", so that:

- investors, not taxpayers bear the cost of bank failures; and
- banks-in-resolution can continue to perform critical economic functions, much the same way that airlines can continue to fly even whilst they are in bankruptcy.

Indeed, nothing galls the public more than the idea that banks and bankers enjoy a "heads the bank wins, tails the public pays" regime.

Accordingly, the G-20 Heads of State have requested the Financial Stability Board to provide at the Australia summit this November an assessment of whether or not banks can be made resolvable as well as an assessment of progress toward that end. Certainly much progress is being made – the agreement on the EU Banking Recovery and Resolution Directive is a case in point. But much remains to be done. As the speakers at the afternoon session outlined, these are difficult but doable tasks, so that at this stage it is plausible to state that resolution is a "glass half full and filling rapidly".

Andrew Gracie, Bank of England, discussed the resolution of financial institutions from the perspective of the authorities. He distinguished between the stabilisation phase of resolution (i.e. the recapitalisation of an institution via application of resolution tools such as bail-in) and the restructuring phase (designed to address causes of failure and restore the firm to viability). The

Thomas Huertas & Santiago Fernández de Lis

stabilisation phase may occur rapidly (e.g. over course of a weekend) whereas the restructuring phase may take several months or even years. Resolution would be designed to ensure continuity of the critical functions of a failing firm, and would preferably be carried-out without cost to the taxpayers. There has been a paradigm shift from bail-outs to bail-ins. The loss absorbing capacity of institutions will be the key to ensuring that those firms can be adequately recapitalised in resolution. Holders of claims on a financial institution should know where they stand in the liability structure. Many banking groups have both holding companies and operating companies – it is often simpler to conduct a bail-in at the level of the holding company. Continuity of critical functions is likely to require, among other things, that the core obligations attached to those functions continue to be fulfilled, that the firm retains access to financial market infrastructures, and the firm has sufficient funding to meet its liquidity needs. It was also noted that significant progress has been made around coordination of cross-border resolutions.

Stefano Cappiello, EBA's Registration, Recovery and Resolution Unit, explained the role of the EBA within the new resolution regime. In 2008, uncoordinated reliance on national resolution schemes and safety nets led to break-ups of financial groups along national borders. There were during the crisis vicious circles between sovereigns and banks and retrenchment of capital across national borders. This negatively affects the proper functioning of the Single Market. The Bank Recovery and Resolution Directive (BRRD) agreed on in 2013 will in the future provide the "legal underpinnings software" for cross-border resolution in the EU. When adopted, probably in May or June 2014, it will ensure that failing banks operating in several countries can be wound down in a predictable and efficient way with minimum recourse to public money. The European Parliament and the Council are expected to agree on the proposed Single Resolution Mechanism (SRM) for the Banking Union. The SRM will complement the Single Supervisory

Mechanism (SSM), which from November 2014 will see the ECB directly supervise systemic important banks in the euro area and in other member states, which decide to join the Banking Union. To make cross-border resolution work across the whole Single Market, not only in the SSM area, we need a strengthening of the legal underpinnings and to make use of the institutional arrangements which the BRRD offers, such as the joint decisions on recovery and resolution planning, of the Single Resolution Mechanism (SRM). We have a big opportunity in Europe to make these arrangements binding. EBA contributes to this process by common rulemaking for the Union, facilitation/mediation of joint decisions within resolution colleges, and benchmarking and peer reviews. The main topics on the EBA-agenda for the months ahead are recovery planning and assessment, resolution planning and assessment, bail-in and MREL, early intervention and resolution triggers, deposit guarantee schemes and intra-group financial support.

D. Wilson Ervin, Credit Suisse, observed that there had been rapid progress in the strengthening of bank capital since 2011, both in terms of common equity and hybrid/ coco instruments. Rapid progress could also be observed in resolution procedures. He mentioned the efforts in the UK, the US Dodd Frank legislation and the FDIC's innovative adoption of SPE bail-in within that framework, the Swiss coco system, and the EU Bank Recovery and Resolution directive. The bail-in concept – which separates critical functions from investor capital, and converts from debt capital to equity when needed, was explained using a simple numerical example. Hopefully, 2014 will mark the end of the global "Construction Phase". The BRRD needs to be finalized. In implementing the new recovery and resolution regime, transparency will be increasingly important. In the past, the lack of ex-ante rules has caused surprises and big problems. Investors now accept the new rules around loss absorption, and price bank debt accordingly. However, they should know the functioning of the new resolution framework and the key financial elements when making their investments.

John Whittaker, Barclays, referred to the structural reform agenda. Ring fencing and the possibility of splitting up activities within big banks are discussed in the Liikanen Report, ICB and other reports. At the end of 2014, regulators are expected to have finished their construction work. The implementation of the new regime will give a lot of work to all in the financial sector. The speaker welcomed the use of a bail-in capability in the resolution of financial institutions in difficulties.

Santiago Fernández de Lis, BBVA, remarked that all institutions started reluctantly the process of recovery and resolution plans but learned a lot in the process. The present discussion on G-LAC (gone concern loss absorbing capacity) is necessary to make bail-in workable, but there are doubts about the cost and investor base of the required paper to cover this new buffer. Cross-border resolution remains a challenge, and there are concerns on global consistency of reforms, given the trends towards ring-fencing and extra-territoriality. As regards the resolution model based on Multiple Point of Entry, it needs to be aligned with a retail and decentralized business model. A hybrid model is possible especially in the Eurozone, in which a global bank can be structured as a Single Point of Entry in the Europe and as a Multiple Point of Entry elsewhere. Important topics in the following discussion were the attitude of investors regarding CoCo-bonds, the risk of litigations due to elements of expropriation in connection with forced conversions from debt to equity, the credibility of swap-lines during resolution and restructuring, access to short-term funding and central bank liquidity support during the recovery phases, the competence and activity of a coming EU Single Resolution Fund and the need to avoid a too complex recovery and resolution architecture in Europe.

Urs Birchler, University of Zürich and President of SUERF thanked in his concluding remarks the organizers, the host, the speakers and the participants for their contributions to a very topical and relevant conference. He appreciated in particular the forward looking nature of the presentations, which stressed the importance of early warning indicators and the crucial role of risk managers and supervisors in the financial industry.