Capital Management in Banking
Senior executives on capital, risk, and strategy

A report prepared by CFO Research Services in collaboration with Ernst & Young
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Enhanced capital requirements loom closer

“April is the cruellest month,” wrote T.S. Eliot. It would be understandable if the world’s banks would largely agree with such an assessment of April 2010. First, the U.S. Securities and Exchange Commission initiated a civil action against one of the world’s most successful and prestigious banks, alleging that Goldman Sachs and one of its vice presidents had withheld material information in connection with the 2007 sale of long positions in a synthetic CDO. The move sent shock waves through financial centers around the globe. Meanwhile, a virulent market contagion threatened to spread throughout the eurozone, as pressure mounted on the bond markets of Greece, Portugal, Spain, and Ireland. The Bank for International Settlements (BIS) estimated in September 2009 that the banks of France, Germany, and the U.K., alone, have more than US$1.2 trillion in exposure to the debt of those four countries. European leaders scrambled to respond to the crisis and secure the euro as workers in Greece took to the streets to protest austerity measures.

“The top three things to get done are capital, capital, and capital.”

But something else has also been under way—something that will arguably have far more profound consequences on the financial system and, ultimately, on the real economy than any of the high-profile events that have riveted public attention this spring: the debate over financial reform.

Measures to increase banks’ capital levels and require them to hold higher-quality capital are prominent in that debate. “The top three things to get done,” U.S. Treasury Secretary Tim Geithner told the New York Times, “are capital, capital, and capital.” As this report goes to press, the U.S. Senate has passed a financial reform bill (which must be reconciled with the financial reform bill, including heightened capital standards, that was passed in the U.S. House of Representatives in December 2009). The final legislation is likely to strengthen capital standards, pursuant to provisions in both the House bill and an amendment, passed with the Senate bill, introduced by Senator Susan Collins of Maine. The final legislation also appears likely to establish a council of regulators to monitor systemic risks. That council would be authorized to issue recommendations to primary regulatory bodies to apply “new or heightened standards or safeguards” to financial practices or activities that, in its determination, “could create or increase the risk of significant liquidity, credit, or other problems” spreading through the financial system. The Senate bill also expands the authority of the U.S. Federal Reserve to intervene in bank activities that are deemed to create systemic risks.

Meanwhile, the Basel Committee on Banking Supervision (BCBS) issued far-reaching proposals for a revised capital framework (as well as new global liquidity standards) in December 2009. The BCBS has proposed four main recommendations for an enhanced capital framework. These recommendations address the quality, consistency, and transparency of the capital base; the risk coverage of the capital framework (in particular, the capital requirements for trading-book and securitization exposures); formal leverage ratios; and the promotion of countercyclical capital buffers. The BCBS is currently conducting impact studies on these proposals, known informally as “Basel III.” Although the Committee is coming under pressure to revise its initial timeline for reform, its secretary-general insists that it remains on track to develop a final set of standards by the end of 2010, with implementation to follow by the close of 2012.

The world’s banks are already holding capital well in excess of regulatory minima, and the interviews we conducted for this research program show that senior bank executives fully expect more-rigorous outright requirements will be implemented soon. Few bankers would deny that proposed regulatory changes to capital frameworks and to minimum capital requirements are likely to affect strategic decision making over the long term. Many of the sources we interviewed stressed the importance of evenhanded application of new capital rules among jurisdictions and financial institutions. Indeed, a lack of uniformity in regulatory application could profoundly alter the competitive landscape. But continued uncertainty concerning the final outcome of these proposals has led most banks to take a wait-and-see stance toward large-scale decisions.
In the spring of 2010, CFO Research Services (a unit of CFO Publishing LLC) conducted a series of interviews with top executives at some of the world’s largest financial institutions. Our goal was to gather and report global financial-services executives’ views on capital management in banking—when, where, and how to deploy capital in an uncertain regulatory environment. What capital management strategies are banks pursuing? How do capital management and strategy development intersect? And what changes are banks making in their practices, policies, methods, and organizational structures associated with capital decision making?

This study is the fourth in the CFO Research/Ernst & Young Bank Executive Series. It builds on findings from our prior study, *Banks’ Moving Target: Sourcing, Analyzing, and Reporting Data in Challenging Times* (January 2010)—that banks face an uncertain regulatory and business environment as regulators marshal their response to the global financial crisis. Perhaps nowhere is this uncertainty more keenly felt today than in the area of capital management.

CFO Research interviewed senior executives at large banks in North America, Europe, Asia, and Australia for this study. We also conducted background interviews with other knowledgeable individuals at banks, regulatory agencies, rating agencies, and other organizations. We supplemented material gathered through interviews with extensive secondary research to develop our conclusions.

We interviewed executives at the following organizations for this report:
- Allianz
- DBS Group
- Fifth Third Bancorp.
- Fitch Ratings
- ING Group
- KeyCorp
- National Australia Bank
- Rabobank
- Shinsei Bank
- Standard & Poor’s Rating Services
- SunTrust Banks
- UBS
- United Overseas Bank
- U.S. Federal Deposit Insurance Corp.
- Wells Fargo & Co.
- Zions Bancorp.

Because this report is based on desk research—including reports from regulatory bodies, firm-issued public statements, and media reports—and background interviews, the statements and findings presented here are based on a variety of qualitative sources and do not represent the views, practices, perceptions, or statements of any named participant in the interview program, unless specifically attributed.
Under current conditions, this wait-and-see approach makes sense. In the aftermath of the global financial crisis, investors in search of reassurance demanded that banks build capital reserves and reduce leverage; in addition, massive injections of taxpayer bailout funds allowed regulators around the world to strongly encourage many banks to hold capital well in excess of current minimum requirements. Although analysts have reported that deleveraging has eroded ROE at global banks by about six percentage points compared with 2000–2006 figures, revenues bolstered by low interest rates and steep yield curves have so far more than made up for lost leverage.

Indeed, our research suggests that many banks’ most urgent capital-related concern is the need to gain a better understanding of risk. In the second report of this Bank Executive Series, Aligning Risk Management, Finance, and Operations (December 2008), we heard from senior finance and risk executives about how banks could reduce vulnerability to future crises while generating appropriate returns. Much would depend, we learned, on banks’ ability to bring strategy, risk, and capital together at the highest level.

The crisis exposed, however, that the quantitative risk models that many banks had come to rely on were inadequate, on their own, for that task. In the 2008 report, we found that banks were already taking steps to improve their ability to understand their risk exposure. These steps included recalibrating risk models with new data; widening the scope of risks under consideration; and, perhaps most important, bringing judgment and experience to bear more consistently to enrich and inform the evaluation of risk models’ quantitative outputs.

Nearly two years later, banks are still working hard to improve their methods and processes for evaluating the risks and returns that lie at the heart of their businesses, as they strive to put increasingly scarce (and increasingly expensive) capital to its best use. For now, capital decisions seem to be relatively easy: more capital, and more high-quality capital, are the order of the day. But as economic and monetary conditions begin to return to something resembling normalcy, our research suggests that capital decision making is about to get a lot harder.

Links among capital, risk, and strategy raise stakes for decision making

Capital, risk, and strategy are deeply connected in banking. Because capital management is inherently linked to risk—and a bank’s risk appetite influences its strategic choices—capital management is the way that risk management finds expression in bank strategy at the highest level. “[Capital] is absolutely interlinked with strategy,” says Eric Williamson, group treasurer of National Australia Bank (NAB). “When we look at capital management, we’re thinking, ‘What’s our strategy? Where do we want to grow?’ Then we think, ‘What’s our risk appetite in each of these areas that we’re focused on?’” A bank’s risk appetite, Mr. Williamson points out, depends on many factors, including its competitive landscape, its existing competencies, and its footprint and growth aspirations. “Do you want to take market share? Are you worried about, for example, the housing market? That might force you to go back on housing. All those things go into that equation. Clearly, you want to deploy capital in the areas where you’re getting your best return,” he says, adding that securing funding for growth also rests at the top of the banking sector’s agenda.

“Everyone, in the depths of the crisis, had a strong bias toward safety.”

The global financial crisis snapped investors’ attention to the quality and size of capital buffers by exposing the fragility of highly leveraged banks—and, at least for now, the experience seems to have turned the dial downward on acceptable returns. “I think everyone, in the depths of the crisis, had a strong bias toward safety. There was no doubt that our franchise was in good shape—no doubt that we were going to make it through,” says Mr. Williamson. “We wanted to make sure we were very strongly capitalized. That was a key thing for everybody. To some extent, the ROE side of things took a bit of a back seat.”
Still, Mr. Williamson says, the focus on ROE never really went away. “Shareholders are always looking through the cycle for long-term, sustainable return on equity, and ROE is a huge focus at any bank,” he adds.

While the markets give swift feedback on a bank’s capital management, their judgments by necessity are made in comparison to other banks’ performance. Capital decision making unfolds in the larger competitive landscape, and capital metrics are fundamental to demonstrating the success of a given strategy to investors and to the public at large. “In terms of strategy, what you look to do is to find where you can excel, or where you can outperform competition,” says Patrick Flynn, chief financial officer of ING Group. “You’re looking to show where you can give shareholders a profit growth and return on equity that’s superior to (a) your cost of capital, and (b) what the competition is doing. Capital is fundamental to that. Cost of capital and return on equity are paramount in proving whether the strategy works.”

The ties between capital and strategy give good reason to predict that changes in capital requirements will eventually lead banks to change their businesses in response. “Particularly where banks have reason to believe that the regulatory requirements on a certain activity exceed what they think the economic capital requirements might be, they’ll adapt their business models to best optimize what they see as the risk/reward characteristics,” says Bridget Gandy, managing director at Fitch Ratings in London. “It won’t happen overnight—it will take time. But that has historically been the goal, and we have seen changes to banks’ businesses over time in the past.” Adds Sharon Haas, managing director at Fitch Ratings in New York, “Basel I is a perfect example. Mortgages were accorded a much lower capital charge then they had been in the past—and the rest is history.”

But even when the regulatory landscape changes, many forces combine to preclude immediate action on a large scale in response. Change, as Ms. Gandy observes, takes time. Our sources point out that it’s much easier for managers to influence growth through capital allocation (by directing additional capital to businesses they wish to promote) than it is to withdraw funding from a mature business. Lingering uncertainty regarding regulatory capital and liquidity requirements will prevent most banks from returning funds to shareholders for some time to come. Uncertainty is also leading most banks to take a wait-and-see stance to market entry and exit decisions, at least for now. And market conditions are less than ideal for divestitures in any case, our sources observe.

“We want to go back to what we were, back to our roots....”

That said, the scale and potential influence of coming reforms are already leading many banks to begin evaluating their current strategies and making plans for large-scale changes. In many cases, these plans seem to involve coming home to core competencies and familiar ground. “We are re-evaluating strategy overall,” says Pieter Emmen, head of group risk management of Rabobank, noting that the group’s cooperative structure requires it to focus primarily on high-quality Tier-One equity capital (as opposed to Tier-Two hybrid instruments or subordinated debt)—which in turn makes it more difficult to attract capital on short notice. “We want to go basically back to what we were, back to our roots as a cooperative bank in the Netherlands, with a focus on international food and agribusiness,” says Mr. Emmen. “Given the fact that Tier-One ratios will have to be high, because solvency will be higher, or we’ll have less capital, we’ll have to change our business profile a bit.... We have to look at how we are doing our activities, how they impact our capital ratios, and at the bank we want to be, based on two dimensions: what is the strategy going forward? And how do we have to structure our business to make the most out of it?” he continues. “We are now looking into all of our positions—to see if we have to either buy or sell them, depending on the impact it has on our capital ratios, our profitability going forward, and the prices you can get for them at this point in time,” he says, adding “given the market it is not that easy to sell something at reasonable prices.”

In the near term, many banks are approaching the allocation of capital to business lines with renewed
discipline and vigor. ING Group, for example, has enhanced the discipline with which it distributes surplus capital generated through business activity. “If you have a large bank with a mature and developed portfolio, the capital it needs is the capital it needs, and that doesn’t get changed overnight,” says Mr. Flynn of ING. “What you can do is bring the surplus capital to the center, and then the group has the power to determine whether it’s prepared to allow further growth or not, whether it wants certain businesses to grow. And if there are growth areas that need additional capital, the bank has a lever to provide more capital, because it holds those funds in the center,” he continues. “We are pursuing the central divesting of profits above benchmark,” Mr. Flynn says, “to operationalize the ability to say yes or no to requests for more capital.”

“It’s discipline, rather than any hugely new conceptual framework.”

The change, Mr. Flynn acknowledges, is a subtle one. “It’s discipline, rather than any hugely new conceptual framework,” he says. But reminding the business lines of that basic planning discipline will be important, he points out, as banks turn toward greater profitability and begin generating more capital.

As the world’s financial system gradually regains its footing, financial institutions are finding that the ability to demonstrate a measure of financial security has served them well among customers and investors alike. At global insurer Allianz, managing capital for ratings purposes has proven to be an important point of competitive differentiation. “Although the business models of banks and insurance companies differ significantly, the differences between an insurance company and a bank are not very great in terms of how you have to manage capital,” says Stephan Theissing, Allianz’s head of corporate finance. “In both industries, the capital allocation is one of the major tools to be used in determining the strategy.” European insurers are also readying themselves for changes in the frameworks that will determine regulatory capital adequacy, he says, as they prepare to adopt the Solvency II regime (roughly comparable to Basel II).

In addition, “managing ratings capital is very important for insurance companies, because in times of crisis the rating is a very important marketing tool for your business…. We’re proud to be one of the best-rated companies in our industry. And we make heavy use of this, so that’s why internally we are doing everything to defend our AA rating—because this differentiates us from our competition,” Mr. Theissing says. “If you look around, the banks that still have a solid A+ or AA rating are getting fewer and fewer, but those that [have these ratings] are doing exactly the same. They are trying to make a selling point to the market and they are using this as a marketing tool.”

True enough, bankers say, and they point out that managing capital even for ratings purposes implicitly encompasses strategy (assessed vis-à-vis profitability) and risk management, in addition to banks’ capitalization and liquidity positions. “As part of our risk appetite, we want to be a AA-rated bank, and that informs how much capital a bank holds,” says Mr. Williamson of NAB. But, he says, “there are many things that are factored in to your rating—how much liquidity you hold, how much capital you hold, how profitable you are, and how good your risk management is. In Australia, the ratings are also influenced by the strength of the Australian government and our operating environment. All those things inform your rating.” He continues, “There’s no point in holding so much capital that you’re the safest entity on earth and your ROE is five percent. You need a strong, profitable franchise to keep that AA rating.” So, although expectations have shifted toward safety and conservatism in light of the financial crisis, the considerations that banks must balance to meet those expectations—capital, liquidity, risk, and return—haven’t changed.
Direction of regulatory reform is clear—but details remain uncertain

In Europe and the United States, which were deeply affected by the financial turmoil, few banks have had the luxury of finding the right balance of profitability, risk, liquidity, and capital to maintain sterling credit ratings. A series of large-scale government interventions have contributed to regulators’ ability, for example, to influence banks’ decision making and to encourage them to hold capital well in excess of regulatory minima. But while few would dispute that most banks should increase capital levels, continuing uncertainty regarding actual regulatory requirements in the absence of clear minimum standards has made managing capital tougher, bankers say. “It’s been difficult to manage the capital at banking institutions during this period because the hurdles, the capital levels that the regulators think are adequate, have moved. The rules haven’t changed, but the consensus among the regulators has shifted higher,” says James Abbott, senior vice president of investor relations at Utah’s Zions Bancorp. Indeed, uncertainty about just how high those hurdles are set may have spurred banks, at least temporarily, into a race-to-the-top competition to demonstrate their safety and soundness by building up capital and liquidity buffers.

But given the aggressive approach that some banks took toward capitalization under, for example, the Basel II regime—particularly with respect to trading-book assets—regulators say they have little choice but to change tack. “Regulators have allowed banks to use a lot of very aggressive approaches to reduce their capital requirements over the years,” says George French, deputy director for bank supervision policy at the U.S. Federal Deposit Insurance Corporation (FDIC). “We’re looking at all of that now in terms of where we went too far and where we need to tighten up capital requirements. So, until we get the rules corrected, which we’re working on, probably the best thing for banks to do is to hold much more capital than the minimum regulatory standards—which they’re already doing generally—and to be sure to consider that, as we learned in the crisis, assets that appear at one point to be liquid and low risk may turn out not to be.” This position is in line with banks’ interests in any case, Mr. French suggests, because “the market looks with disfavor on companies that it considers to be weak from a capital perspective.”

So, as they wait for the final regulatory response to the crisis (and strive to influence its outcome), banks have also taken steps to prepare for the inevitable. “I think banks fully accept that a lot of the capital strengthening and deleveraging that they’ve done over the last couple of years is really in anticipation of that sort of regulatory response,” says Richard Barnes, a director at Standard & Poor’s Rating Services in London. “The Basel consultation paper sets out a range of options, and some are clearly more punitive than others. I think banks are hoping that the [final outcome of reform] is reasonable, and that there’s a realistic transition period that will enable them to adapt to the new requirements.”

“The issue is not so much the change to Basel III per se…. It’s more a question of the number of different bodies that want to interpose on this space.”

Banks are also hoping for consistency and coherence: that is, banks are pressing for new regulatory standards to be applied evenly across jurisdictions and for the full range of rules governing capital structure, risk weighting, liquidity, and leverage—including accounting rules—to form a coherent framework. “The issue is not so much the change to Basel III per se—although uncertainty is obviously something that concerns people. It’s more a question of the number of different bodies that wish to interpose on this space,” one European banker says. “The industry can deal with Basel III proposals, but there’s more of a concern if you get others like the EC [the European Commission, the executive body of the European Union] seeking to create rules in the same arena, and potentially accounting rules as well. To the extent that the outcomes might be conflicting, that is where there would be a real concern over how you manage in that framework.”
Consistency and coherence, sources say, would help promote fair competition among banks operating in various jurisdictions around the world—and also among banks and nonbank financial institutions. “In many markets, you can see that banks and insurance companies are fighting for the same dollar,” says Mr. Theissig of Allianz. “This does not mean that an insurance company has to have a bank or has to behave like a bank—the underlying business models are still very different. But we will see more competition from banks in our industry. Banks are in the so-called asset-gathering or savings-gathering business, and insurance companies are in the savings-gathering business as well. So that’s why the insurance industry is working to make sure that the introduction of Solvency II doesn’t create any artificial or additional imbalances in the environment between insurance companies—although as far as I follow the discussion, there’s no risk. I think this sort of regulatory arbitrage business is finally being put to rest under Solvency II—and that’s good,” he says.

“It’s the great dilemma for the banking industry. How do you earn a return on this extra capital?”

Although regulatory change creates some risk that new pockets of regulatory arbitrage will arise, executives also observe an opportunity to level the competitive playing field for all. “In terms of a level playing field, the Basel III rules will play a role,” Mr. Flynn says, adding that ING would welcome additional clarity and comparability. “For example, the leverage ratio was picked up by the market as a ratio that should be looked at, and a big issue with it was how it should be computed. What are the rules? Everybody computed it in different ways. And then you have to ask what role it should play. Does it have a hard limit, or is it a Pillar II-type reference point? These are fundamental questions that need to be answered. If they’re answered well, this regulation can have a very useful role in defining the competitive playing field, one we would welcome—and perhaps one that might have identified problems in the past,” he adds.

But even as banks look forward to some relief from regulatory uncertainty, changes are already stirring that hint at the issues they’ll soon face. Although Greece’s sovereign debt crisis struck a blow to investor and consumer confidence in the spring of 2010, economic recovery generally seems to be gaining traction. Governments eager to refill their coffers after two years of heavy spending are beginning to withdraw their support for the activities that have helped many banks to make a swift return to profitability. Consumers conditioned over two decades to expect inexpensive credit—and conditioned to the privations of the Great Recession—may choose to forgo credit rather than pay the rates that banks must charge to support thicker capital buffers. And investors—anxious to recover their own losses—are likely to become less tolerant of more-subdued returns on bank equity as financial reforms are enacted.

So the level regulatory playing field that banks are hoping for may, in fact, be one of banks’ best defenses against investor disappointment as ROE falls in tandem with leverage. Evenhanded application of regulatory reform would ensure that banks compete for investor capital from the same (or at least a similar) position. But even that might not be enough to keep investors from withdrawing from the banking sector in search of investments that they anticipate will produce more-favorable returns on equity over the long term. Solving the problem of producing the results that equity investors will expect is indeed one of the central problems in banking. “It’s the great dilemma for the banking industry,” Mr. Abbott says. “How do you earn a return on this extra capital? If the banking industry is targeting a 15 percent return, but the capital levels are double what they were before the crisis, how are we going to get there?”
Efforts to understand risk take on renewed urgency

It is universally accepted that perfect coordination among regulatory bodies, resulting in the uniform application of new capital standards to banks around the world, is—to put it mildly—unlikely. It is equally accepted, however, that capital and liquidity standards the world over will soon become more stringent. The pressure for greater transparency into the risks that banks are taking, including the elimination of various off-balance-sheet structures that have effectively reduced banks’ capital requirements in recent years, is unlikely to fade anytime soon. So how banks plan to produce the kinds of returns that investors—especially those that hold the purest forms of equity—will expect in coming years is becoming an increasingly urgent question.

At this point, it's too early to know the extent to which investors will be willing to adjust their expectations for growth and returns, too early to know the extent to which consumers will accept higher prices, too early to know whether regulatory reform will force banks to gradually withdraw from activities to the detriment of the real economy. Bankers, regulators, legislators, and interested observers are studying and debating these issues now, and many of our sources acknowledge that there are reasons to be optimistic that the ultimate outcome of this debate will be positive.

In the meantime, banks are focusing on improving their ability to deploy their capital effectively in order to generate adequate returns that will compare favorably with those of their peers, no matter what the future holds. Executives interviewed for this study recognize the very real possibility that high rates of return will prove more difficult to attain (although returns may prove to be more stable and sustainable) in the regulatory future that’s currently taking shape. As a result, the stakes for determining the right business strategy and executing it well are high indeed.

If the very high leverage and high levels of risk exposure that banks were allowed to assume in recent years presented one clear strategy for growth—make ever-bigger, ever-riskier bets on rising asset prices—many bankers now concede that the intervening crisis illustrated the extent to which perceptions of risk and return had become detached from each other in many pockets of the financial sector. (In fairness, they point out, a similar dynamic took hold in many other sectors.) “Before the crisis, most organizations, including banks, were often satisfied by looking at returns without linking [them] to risk. I think the crisis actually reminded us that the two are linked together,” says Lee Wai Fai, chief financial officer of Singapore’s United Overseas Bank, adding that banks link risk and return in part through capital allocation. “Banks have to look at how much capital they set aside, in part to make sure that they are being paid appropriately for [doing so].”

“I think the crisis actually reminded us that [risk and returns] are linked together.”

Banks that weathered the financial crisis particularly well seem to have done so in part by avoiding positions in which the potential downsides, however unlikely they may have seemed, catastrophically outweighed the upsides. But avoiding these asymmetric risk positions required banks to recognize the full range of potential downsides and ensure that they were priced adequately into deals (if they could be priced in at all)—something that even some of the most sophisticated institutions found difficult to do well. By contrast, Wells Fargo & Co. has made a point of avoiding asymmetric risk positions, says treasurer Paul Ackerman, in part by making a point to avoid situations in which complexity could be masking asymmetry. “When you look at some of the mortgage instruments that people invested in, I think it comes down to two things: You have to understand what you’re doing—and I would argue that some institutions perhaps didn’t understand what they were doing in several of the products they were in. And then you have to ask, ‘Is it a horribly asymmetric risk?’ [Wells Fargo] won’t do either of those things. I don’t think we’re going to change much. I think the industry needs to make sure it addresses those two principles.”
“Determining risk-based capital is predicated on the fact that the calculations of the risk profile are done correctly....”

Growth in coming years will depend in part on banks’ ability to reunite the concepts of risk and return, to ensure that they’re striking the right balance between the two—and to ensure that they’re being compensated appropriately for the risks they do choose to take. At the same time, minimum capital requirements and limitations on leverage are likely to raise the stakes on banks’ efforts to deploy capital efficiently; with regulators and investors watching closely, banks that are able to understand risk best will reap better returns, while making a more convincing case for their safety. More than a year after our first report on risk management in banking, sources tell us that they have made great strides in understanding the full extent of their risk—and in understanding the true value of their business activities. But, they say, there is still more work to be done.

A wide range of risk management improvements

Few would dispute that the failure of sophisticated models and methods (including value-at-risk [VAR] methodology, stress testing, and economic capital) to fully anticipate the adverse events of 2007–2009 left the financial system extremely vulnerable. Decision making suffered in part due to the paucity of data documenting the assets that underpinned the riskiest transactions, an overreliance on data at the expense of human judgment, and widespread misconceptions about the output of risk models. “In any organization, determining risk-based capital is predicated on the fact that the calculations of the risk profile are done correctly, and that the root data in terms of representation of the risks from individual transactions and so on is correct—or that it proves to be correct,” explains Philip Lofts, group chief risk officer of UBS. “In essence, what you’re doing is developing a forward indication as to the potential level of loss from a portfolio of transactions. If those risk models prove to be wrong and significantly underestimate the tail risk in the portfolio, then this will have significant ramifications with regard to computing the necessary capital needs for the portfolio,” he says, pointing out that regulatory controls such as caps on leverage are gaining traction as a result. “Leverage ratio is gaining momentum partly because it’s risk insensitive, and therefore provides a brake in the system.”

But even with all of their limitations, banks and regulators alike continue to recognize the value of sophisticated risk models, stress testing, and scenario analysis. Indeed, our interviews indicate that banks have developed a better appreciation for the limitations of their risk models in the aftermath of the crisis and, sources say, a better understanding of how to use them effectively. Stress tests, too, have benefited from close attention from regulators using them to test capital and liquidity adequacy. “The Fed [U.S. Federal Reserve] has put a lot of rigor around how banks do stress tests, why they do them, and what the outputs would be,” Charles Hyle, chief risk officer of KeyCorp, observes. Stress testing is “a much better way to try to figure out what might happen in the future than always looking in the rearview mirror at historical information,” he continues.

Banks are also working to improve their use of economic-capital and economic-profit methodologies to understand the risks and the returns associated with their activities more fully. Rahul Gupta, chief financial officer of Shinsei Bank, expects the rollout of new economic-profit models will help Shinsei deploy its capital more efficiently; he and other sources we spoke with anticipate that banks will work to make more and better use of economic-capital and economic-profit models in the years to come. But he also points out that making good use of these methodologies may mean working to keep them simple enough for decision makers to grasp—and helping managers understand how to put outputs in context. “We believe that the only way going forward is to look at risk-adjusted return on capital—for everything that an organization does, shareholder value is either added or it’s destroyed,” Mr. Gupta says. “Our principle is to keep it simple, a little bit of a ‘less is more’ approach, just get some directional measurements of shareholder value and move that forward.” He continues, “In my experience within banking and financial services, people can start doing something resembling nuclear research;
they’ll attempt to get to the nth level of detail at the nth level of accuracy. In the pursuit of academic excellence, it can become so complex that people don’t understand it.” He adds, “If people in key positions across the organization don’t understand what you’re trying to measure and how you’re trying to measure it, you’re not going to get buy-in.”

While many banks work to improve their methods for evaluating economic capital and economic return, our sources also note that the quality of information—the depth, breadth, accuracy, and precision of their data inputs—has improved in the aftermath of the crisis. Banks’ risk models, for example, are benefiting from an enormous amount of new information about the way their individual businesses, the financial sector, and the larger markets in which they operate behave in distress. “Clearly, there are a whole bunch of new data points that have now been captured,” Mr. Williamson of NAB says. Since the efficacy of risk modeling depends in part on the quality and comprehensiveness of the historical data models consume, data points generated in the past two years should, in theory, improve their output.

But bank executives also observe that adjusting models to take new data into account won’t be easy, especially in the most troubled markets, and that the ultimate results of these recalibrations will affect the price of credit for consumers. “In the future, one of the biggest challenges associated with effective capital allocation will relate to estimating the credit losses associated with certain loan products,” says Mark Chancy, chief financial officer of SunTrust Banks, Inc. “All of the models will need to be recalibrated to reflect the recent environment, in which losses have been well above expectations, particularly for consumer loans such as mortgages and home equity lines of credit. The actual losses during this cycle will cause a re-evaluation of the amount of capital that needs to be held against these assets to generate a suitable risk-adjusted return. This recalibration should ultimately translate into banks’ appetite to hold the assets on their balance sheets and, therefore, the price at which they are willing to originate the loans.”

The profound consequences of banks’ ability to understand the risks they take—not just for individual firms, but for the financial system and the real economy—may partially explain why bankers continue to caution strongly against overreliance on risk models at the expense of well-informed human judgment. Models that fail to take relevant data and events into account in the first place can easily produce misleading outputs. Good judgment, in part, involves understanding not just what models affirmatively take into account, but also what they leave out. Although Wells Fargo certainly makes use of sophisticated models to gauge risk and shareholder return, Mr. Ackerman says, “I think that the worst way to go is to focus on getting more data. Banks already have so much data, and it will never tell you the answers [on its own]. You need to think critically about [the models’] inputs.”

“Banks already have so much data, and it will never tell you the answers [on its own.]”

But banks aren’t just widening the scope of risk information; they’re also considering more types of risks as a result of the crisis. Rather than concentrating on a relatively circumscribed set of risk factors, banks are regularly examining a wider range of residual risks in addition to credit, market, and liquidity risks. Even regional banks are looking more closely at the full range of risks that may reside in their activities. “Perhaps the industry was a little underdeveloped in the consideration of things like reputational risk, or certain types of operational risk, or maybe even the category of strategic risk,” says Mary Tuuk, chief risk officer at Fifth Third Bancorp. Now, she says, “there’s more granularity of risk categories.”

Regulators, too, are looking more closely at categories of risk that weren’t fully appreciated before the crisis, including exposures such as the reputational risk embedded in the use of off-balance-sheet structures. “Our capital requirements haven’t really captured off-balance-sheet activities very well, especially if the bank doesn’t have any legal or contractual obligation to support those off-balance-sheet entities,” Mr. French of the FDIC says. “We learned, in fact, that banks often have a business or a practical obligation to do so, and we saw during the crisis that banks were coming to the support of those off-balance-sheet activities. Things
came back on balance sheet very rapidly during the crisis, and banks would suddenly find themselves short of capital to deal with them,” he says. While changes in accounting rules that went into effect in early 2010 did much to alleviate that problem by bringing many of those activities back onto the balance sheet, regulators are also working to do a better job of capturing those activities with risk-based capital rules, Mr. French continues. “In some cases,” he admits, “it’s hard.”

“We’ve been focusing a lot of our thought and time on how to improve our understanding of the interdependencies of risks.”

Taking the full range of relevant risks into account when deciding how to allocate capital is challenging in part because banks are still working to fully understand how risks interact with one another. At many banks, managers worked in the aftermath of the crisis to understand whether—and how—economic-capital methodology could capture correlation, systemic, and counterparty risks. “We went through a period about nine months ago when we wondered whether EVA and economic capital—risk-adjusted capital—actually failed us, or whether it worked pretty well, but maybe not as well as we thought it might,” says Mr. Hyle of KeyCorp. In the end, the bank concluded that economic-capital methodology yields valuable information, but it may also have “two major shortcomings,” he continues. “First of all, does it react quickly enough in periods of great change and great volatility as a leading indicator? And the second and probably more fundamental question: Did it really help us understand the correlation of risks across the entire organization and across the entire industry? We’ve been focusing a lot of our thought and time on how to improve our understanding of the interdependencies of risks,” he says.

Banks that are interested in understanding risk correlations better are looking beyond economic capital and other methodologies to get to the right balance between qualitative judgment and quantitative data, Mr. Hyle says. “You can get lost in the quantitatives,” he says. “One thing we all learned from this crisis: model output is interesting, but it doesn’t always tell you everything you need to know. It’s also based on historical data, which doesn’t necessarily tell you where the world is going. A lot of this is still judgment, experience, and observation—things that happen way over here ultimately have an impact way over there,” he continues. As part of its effort to gain the full benefit of its executives’ judgment and experience, KeyCorp has set up an enterprise risk management committee, Mr. Hyle says, admitting that the term committee “sounds horribly bureaucratic.” But the ERM committee at KeyCorp, Mr. Hyle says, is anything but an empty bureaucratic exercise.

In fact, the committee’s meetings are a high-level forum for top executives to bring their collective judgment to bear on a wide range of risk-related matters. “The committee is [composed of the] top six people in the bank,” he explains. “We talk every week about specific risk issues, whereas in the past we had a credit risk forum, a market risk forum, an operational risk forum, and a compliance risk forum, each of which functioned well in its own right, but which didn’t consider the interconnections among those things as much as it needed to.” KeyCorp’s enterprise risk management committee, Mr. Hyle says, is chaired by the bank’s CEO. “I’m the vice chair,” he continues, “and our CFO and our business heads are also on it. We devote at least a portion of every agenda to the interrelationship of risks, and how something happening over here will potentially impact other aspects of the business.”

As a result of these and other efforts, managers at KeyCorp have become much broader in their thinking, Mr. Hyle says. “Because we have a lot of experience at the table, we will raise issues and just talk, blue-sky a bit about where we think that might impact us. For example, a couple of weeks ago I raised the issue of the Greek country-related risk,” he continues, noting that problems with Greek sovereign debt seem, on the surface, to be far afield from the bank’s operational scope. “KeyCorp has no significant international operations. We certainly don’t do anything in Greece. A year or two ago, that wouldn’t have even been on anybody’s radar screen. But because of the potential impact on bond markets and foreign-exchange markets, we felt it was a relevant point of discussion to ask, ‘What impact is that going to have on us? What do we need to do to prepare
ourselves for that potential impact?"

The breadth of issues raised in the bank’s enterprise risk management committee, Mr. Hyle says, mirror the renewed depth and breadth of its stress-testing efforts. "We’ve always done stress testing, but again, we’ve tended to do it historically in specific areas—we stress tested this portfolio, or that portfolio, or that business.” He continues, “What we’ve been doing now for over a year is stress testing all aspects of our business—setting up economic scenarios and developing models to see how each of our businesses will react to these economic impacts, then taking that output to see what the impact would be on our capital levels, our balance sheet, our P&L. It’s a very coordinated effort now, rather than doing it piecemeal around the organization,” he explains.

“[Stress-testing] is a very coordinated effort now, rather than doing it piecemeal around the organization.”

Other executives we interviewed also confirm that their banks are forming organizational structures—ranging from new committees to full-on reorganizations—that mirror their broader, more-comprehensive approach to risk. In many cases, banks are working to bring related concepts, like risk and return, or the supply and demand for capital, into closer alignment. Two years ago, senior bank executives around the world told us that the crisis had brought home the need to bring finance and treasury, risk, and operations into closer alignment. Today, our sources confirm that banks have made progress toward that goal—and capital management has proven to be one of the activities through which banks have united critical concepts and key functions.

DBS Group in Singapore, for example, brought the supply side of capital management (including capital raising, managing the cost of capital, and dividend policy) together with demand-side management of balance-sheet assets and liabilities under the auspices of the treasury function in finance, says Philip Fernandez, head of DBS’s corporate treasury. The bank, he says, “came to realize that integrating traditional capital planning and the management of assets and liabilities was crucial for sustainable earnings growth,” adding that finance (which historically has concerned itself with capital supply) and risk (which until recently concerned itself primarily with the demand or consumption of capital) were working together more closely as a result. “What we’ve seen in a relatively short space of time is that we can actually leverage a lot more of the work that happens in both the risk and the finance space,” Mr. Fernandez says.

At United Overseas Bank, CFO Lee Wai Fai says, “I think today we definitely look at risk and capital together. We’ve actually formed what we call the capital risk committee, to formally link risk and returns together. Previously, the risk management function dealt just with the technical aspect of risk, without understanding the business implications. Today, risk management will look at certain models, determine the degree of risk involved, and, as a result, identify the capital that’s coming out from the system,” he says. Finance’s role is to “evaluate the return on that capital—we have X dollars of capital to deploy and Y dollars of expectation from shareholders that they expect to earn from this capital deployment,” adding that the bank also cultivates a healthy debate about the outputs of these assessments among risk, finance, and the business lines. “In a way, it’s a good thing that the line people now are aware of the risks that they are taking, because previously risk management would compute something that, to a lot of people, would just be a technical number with no real business sense to it. But today, there is a fuller awareness of the business implication to the risk that we are taking. The [line] people will start questioning if this credit line is worth what we’re charging: Can we increase the pricing? If not, do I have alternatives? So in that sense, it has brought not only finance but risk closer to the businesspeople,” Mr. Lee says.
What will the future hold?

Even banks’ toughest critics in the aftermath of the financial crisis have spared some sympathy for at least one dimension of their dilemma: that banks are under a combined set of pressures from regulators, investors, and the public to rationalize their balance sheets and recapitalize themselves, and at the same time to continue lending in service of their core social function as credit and financial intermediaries. “Two totally incompatible goals,” journalist and banking-industry critic John Lanchester noted in his most recent book, *I.O.U.: Why Everyone Owes and No One Can Pay.*

Or are they? Not, perhaps, if banks are successful in returning to what they know best. “It all comes back to loan underwriting,” says Mr. French. “That’s what banks historically have been good at. Sometimes the risk gets a little out of hand and we pay the price, but well-managed banks know how to underwrite loans. We think that’s the bread-and-butter business of banking, and we hope that banks will continue to emphasize the basics and make good loans. That’s sort of the bottom line.”

Opinion among our sources varies widely on whether the banking industry will moderate its behavior over time in response to the global financial crisis, or whether the latest crisis was just the first deep trough in a new boom-and-bust cycle. Some bankers argue that a new spiral of increasingly risky behavior is probably inevitable. “Isn’t this just normal fear versus greed?” asks one bank executive. “When you’re fearful, you’re less greedy; when you’re greedy, you’re less fearful. I would bet my last dollar that in five years there will be a [less conservative] mode of behavior [than there is today]. Public memory is short.”

Whether a new spiral of excessively risky banking activities will in fact take shape in the coming years will depend, in part, on how well regulators are able to circumcribe the riskiest activities and safeguard the financial system as a whole. Of course, the reforms currently under debate will play a critical role in that effort. But regulators are also considering both how to take a more proactive approach in good times, when risks are accumulating in the financial system, and how to avoid any possible tendency toward regulatory capture. “During the boom times, there’s a tendency for regulators to be more influenced over time by the banks,” Mr. French says. “It seems like risks are far away on the horizon. There are no problems in sight, and it becomes a lot easier to agree with banks that are saying, ‘There’s no problem here.’ I think every regulatory body is looking at that, doing a self-assessment, and thinking about ways to take a more proactive and aggressive approach during times when the risk is building, as opposed to after the crisis has hit.”

Regulators are likely to play a more active role in the aftermath of the crisis in curbing the accumulation of excessive risk throughout the financial system, but much will also depend on banks’ own ability to direct their efforts—and their capital—toward activities that yield the best returns possible without compromising their soundness. Toward that end, several of our sources...
note that one of the best defenses against the shortness of memory, and perhaps one of the best paths to risk-appropriate returns, is a strong risk culture. The challenges of the past two years have doubtless strengthened culture at banks around the world. Even so, our sources observe that developing a strong enough sense of culture and identity to guide behavior in times of distress takes time, effort, and attention. KeyCorp’s strong corporate culture served it well during the crisis, notes Mr. Hyle. “I think one of the things that has emerged from this crisis is that those institutions that have very strong cultures have tended to perform better than those that don’t. It doesn’t necessarily mean they have the same culture; it’s just that they have a culture,” he says. “In times of crisis and volatility, people with a strong culture instinctively know what to do.... I think the industry has underestimated historically how important a strong, consistent, firmwide culture is in terms of managing not just risk, but managing the business as a whole,” he continues. “We’re spending more time on culture—on training and on creating a consistent culture across our organization—than we ever did in the past.”

“So how do banks foster that kind of culture? “Well, it perpetuates itself,” Mr. Ackerman says. “I learned a lot from people who are senior to me. They taught me a lot along the way, and they’re still teaching me a lot. That’s reflected in the way I deal with my staff. One of my mantras is that you cannot come to a meeting with a bunch of numbers if you don’t know each and every number on the page. And by ‘know it,’ I mean being able to answer questions like: Do you know why that number is there? What could go wrong with it? Do you have confidence in it, or not? Any conceivable question about a number on a page, you are expected to know. That was drilled into me when I started out, and now I’m drilling it into my staff,” Mr. Ackerman continues. “That’s the process by which culture gets passed on.”

As they prepare to meet enhanced capital and liquidity requirements, banks are drawing on a combination of new organizational structures, improved information and models, better decision-making processes, stronger internal and external relationships, and a renewed sense of corporate culture and identity to help them adapt—and even thrive. The challenges remain formidable, but banks seem to be drawing strength and confidence from the improvements they’ve made since we issued our 2008 report on risk management in banking. And even after nearly two years of disruption and often painful adaptation, our sources at banks around the world say they appreciate the opportunity to make a contribution to the effort. “Despite all the headaches of the last couple of years, I’ve really enjoyed reorienting our enterprise risk management operation here—expanding it, developing it, and deepening it. I’ve had great satisfaction from the effort, because I think it really does have a big impact on how we do our business,” says Mr. Hyle of KeyCorp. As bank executives hinted in our last report on risk management in banking, the silver lining of unprecedented adversity is unprecedented opportunity to effect positive change. As the spring of 2010 draws to a close, banks seem more determined than ever to make the most of that opportunity.

“Mr. Ackerman of Wells Fargo agrees that culture has an important role to play in risk management. Although Wells Fargo is “very intentional about appropriate oversight, we think the job of managing the firm’s multiple risks is actually too big for one person or committee, even at the board level,” says Mr. Ackerman, noting that at the board level, risks are managed by several committees—not just one—to ensure that the bank spends adequate time on each type of risk. “We want the people who are running the business also managing the risk, because otherwise, you’re not running a business. In a risk-taking shop—and that’s what banks are, right?—if you don’t manage that risk, what are you managing?” he asks. Capital decisions that reflect risk well, Mr. Ackerman says, ultimately flow from a culture that values continuity and experience.
Banks respond to reform: Improving alignment among strategy, risk, and capital

Capital Management in Banking appears at a critical juncture for the industry. Banks around the world are preparing for the wave of reform that is approaching due to Basel Committee proposals and possible legislative action requiring revisions to regulatory capital standards. How well a bank is able to respond to that wave of reform may prove critical to its ability to align strategy, risk, and capital and produce competitive risk adjusted returns.

The current state of financial reform
The broad structure of financial reform is already taking shape (barring additional country-specific changes in local jurisdictions), and most observers agree that a major component of the reforms will be the Basel Committee’s far-reaching proposed overhaul of capital and liquidity frameworks. Few aspects of banks’ businesses will be unaffected by these changes. The revised regulatory capital framework is likely to include higher capital charges on certain activities, including structured products, counterparty credit exposures, and trading book portfolios. It is likely to include a greater focus on banks’ own estimates of capital demand through a more formalized assessment of key risks and the use of enterprise stress testing as a complement to economic and regulatory capital.

The revised framework will define available capital more narrowly, with an increased focus on tangible common equity. And, as an additional constraint, a global leverage ratio is also likely to be introduced. Regulators will likely define standards for capital buffers more explicitly, assessing capital adequacy over a multi-year horizon with an eye toward maintaining market confidence in the industry’s ability to take a hit without having to constrain credit availability. This, in conjunction with other possible adjustments to credit risk measurement standards, is intended to address concerns related to the pro-cyclicality of current capital requirements.

Regulatory reforms also promise to influence the way banks report, assess, and assume risk. Strategy and risk appetite will have to be more transparently defined and explicitly monitored. Since the risk of financial contagion can be reduced, but not eliminated, large, complex institutions may also be required to prepare recovery and resolutions plans (or “living wills”), which are intended to allow institutions to reduce systemic risk by taking actions today that will increase banks’ options for recovery in the event of a firm-specific or broader market crisis and to ease their resolution in the event of failure. Proposed reforms also provide the tools for supervisory bodies to better understand systemic risks and to be better informed if or when public intervention is required.

Although reform is expected to be massive in scale and scope, regulators are moving swiftly to establish the new regulatory framework. The Basel Committee published its consultative paper on proposed framework changes in December 2009. While the results of the recent quantitative study conducted to assess the impact of these proposals are not yet in, industry feedback suggests that significant recalibration may be needed to the overall framework before it is ready for implementation. Even so, there appears to be strong momentum for the Committee to finalize the standards by year-end 2010, even if questions of calibration remain to be resolved. Implementation will then have to proceed according to local legislative and/or regulatory processes in each jurisdiction.

In the interest of revising the global framework quickly to respond to the financial crisis, some complex issues may be pushed into the future or left to local regulatory discretion. And even after the new regulatory framework is established, banks may experience a lengthy period of lingering uncertainty. Legislative reforms and new regulations in many local jurisdictions, for example, will take some time to be enacted and implemented. They could have a significant impact on local, and potentially global, markets. Regulatory reform may require a large-scale response from banks over the medium- and long-term, as they adjust to the attendant changes in their operating and competitive environments.
The changing business of banking
Given the broad range of proposed reforms, regulatory changes may have unintended consequences that will influence what types of businesses are attractive to banks and in which jurisdictions, with concomitant implications for financial markets and possibly real economic activity. There is some indication that this process has already begun.

Financial markets significantly changed as a result of the financial crisis. While certain products will be revived, others probably will not be—at least not in their prior forms. As the financial reform framework is further defined and, importantly, recalibrated, the attractiveness of certain products and businesses is likely to change further.

To make strategic decisions with confidence, banks must have a firm grasp of the risks inherent in their various activities. As we move into this post-crisis environment, we expect that the assessment of strategy, risk, and capital will become more sophisticated, more integrated, and more nuanced. While institutions historically used relatively standardized or industry-accepted metrics for assessing risk and risk-adjusted returns—and investors in the past proved willing to accept these metrics—there is now a greater understanding that standardized metrics alone are not sufficient for understanding risk across the organization. Banks, regulators, and investors are seeking to expand the range of risk models, e.g., VAR, stress, macro shock, and company shocks. Stress testing and the periodic reassessment of how the businesses can be expected to perform across all material risks are also likely to become increasingly prominent in the understanding and management of risk and in the management of capital and liquidity.

This more-complex understanding of risks and emerging vulnerabilities is likely to help banks to identify potential disconnects between risk appetite and business decisions more proactively. But it also complicates the communication of risks, given the need for multiple customized metrics to fully articulate risk profiles (as opposed to the use of single metrics).

As the business of risk taking and the requirements of operating across jurisdictions and legal entities, subject to increasing local demands, have became more complex, so has the business of assessing risk and making business decisions. The CFO and CRO and their organizations continue to work more closely together to assess risk and capital and to support strategic decisions.

Next steps
Over the medium term, banks will likely focus on the following areas:

**Reassessment of business strategy.** Many banks will consider reallocation of capital to businesses that have the potential to offer higher risk adjusted returns under new requirements. Some businesses may become less attractive or even not viable given increased capital and liquidity requirements. At the same time, robust capital allocation and performance measurement methodologies and infrastructure will be necessary.

**Analysis and implementation of capital optimization opportunities.** As the reformed financial framework increases capital requirements and tightens capital supply for most firms, there will be a renewed impetus to look for efficiency opportunities as they relate to required capital—both through changing risk-taking activities and through enhancements to methodologies and infrastructure for calculating regulatory capital.

**Monitoring and revision of capital adequacy goals.** Banks will continue their work to link financial and capital adequacy goals to risk appetite through the capital planning process and stress testing. With the introduction of explicit regulatory liquidity standards, balance sheet management techniques may need to be adapted to a greater intersection of capital and liquidity constraints in business and strategic planning.

**Reduction of the complexity of business operations and rationalization of legal-entity structure.** In response to requests for formal recovery and resolution plans and a focus on reducing the systemic risks of large, complex multinational institutions, combined with greater...
demands by local regulators to meet local regulatory capital and liquidity standards, institutions will increasingly assess their business structures and identify steps to reduce unnecessary business complexity and minimize trapped capital and liquidity.

**Improvements in reporting.** Many banks will continue to focus on improving the information that is available to the board, senior management, and line-of-business managers. Banks will also focus on getting timely, accurate, easily digestible, actionable information into the hands of the right individuals. Risk and finance reporting is likely to become more integrated. In addition to periodic standardized management reporting, institutions will seek to provide greater on-demand access to information through better use of business intelligence technology.

**Improvements in data quality and systems.** The demand for more information, of higher quality, at a greater frequency, and readily transparent and reconcilable across the organization continues to grow. The increased demands from business needs, regulatory requirements, and accounting changes is pushing institutions to continue to expand the number of data elements that must meet the highest data-quality standards and can be linked across multiple distinct views of an organization that integrates business, risk, and finance information. To provide this integrated view of their organizations, banks will likely need to further invest significantly in both their risk architectures and their approach to data management.

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