A set of blueprints for success

Seventh annual global EY/IIF bank risk management survey
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Executive summary

Delivering a blueprint for success: completing a 15-year transformation of risk management
Banks have faced considerable headwinds since the financial crisis. Although many economies have recovered from the post-crisis doldrums, the improvement has been turbulent and the low interest rate environment has created continuing pressures on earnings. That pressure has been exacerbated by widespread conduct failures, resulting in large fines and remediation costs. At the same time, banks are under pressure from shareholders to increase return on equity (ROE), which is a struggle given the continuing upward path of capital and liquidity requirements. The sheer breadth of the global regulatory agenda has demanded considerable attention and resources from management.

Since 2008, banks have materially strengthened their risk management approach. From the board level down, significant investments have been made to risk, compliance and controls. Headcount in control functions has increased considerably, as has the seniority and scope of the risk and compliance functions.

Over the last seven years, EY, in collaboration with the Institute of International Finance (IIF), has monitored the industry’s progress in improving risk management through a series of annual surveys of large financial institutions globally. This year, 67 banks from 29 countries participated in the survey. This included 23 of the 30 institutions designated as global systemically important banks (G-SIBs). Senior risk executives completed online surveys, were interviewed, or both.

What is clear from the survey is that change needs to continue. Seven years on, the industry is searching for the appropriate blueprints for the next phase of the journey.

Banks are asking:

- What is the best design of control responsibilities across the first and second lines of defense? How do banks achieve effective first-line accountability?
- What is the best way to identify and manage non-financial risks and approach them as separate risk types?
- How do banks move to a sustainable business model?

Answering these questions will be essential for banks to attain a more stable earnings trajectory.

In reality, banks may be halfway through a 15-year journey. Good progress has been made so far, but the work ahead remains substantial.

### Meeting ROE commitments to investors

ROEs have come down considerably in the aftermath of the financial crisis. Most banks are under tremendous investor pressure to achieve higher and more stable returns by changing their business model or reducing costs. In this context, banks seem to be converging on industry norms of three-year ROE targets of 10%-15%. The convergence can be seen across G-SIB and non-G-SIB banks – some have reduced their targets, while others have increased them. The question is, how do banks deliver against these commitments? This year’s survey points to several interrelated elements:

1. **Banks have to properly implement the three lines-of-defense model.** First-line accountability needs strengthening, but so does the second line. Banks are clarifying what the business is accountable for, through revised incentive structures, training and enhanced management-information reporting. It is a balancing act across the lines: banks know the results they want to achieve, but there is less agreement about how best to distribute control functions across the first and second lines.

2. **Banks have to manage non-financial risks more effectively.** The challenge is applying techniques being experimented with across the industry and designing and implementing a blueprint for long-term success. Embedding these risks more effectively into the risk appetite framework is essential.

3. **Banks need to continue their search for the blueprint for strategic success.** In the short term, the ongoing implementation of the global capital and liquidity agenda will make tactical and strategic adaptation the name of the game. Regulatory uncertainty, due to new proposals, changing implementation deadlines and differences across jurisdictions, will be with banks for a while. Ultimately, however, they need a stable, sustainable business model appropriate for the demanding regulatory environment.
Effective implementation of the three-lines-of-defense blueprint

Banks have greatly stepped up their efforts to make a fully functioning three-lines-of-defense approach to risk management work. They are no longer merely rethinking the framework; they are on the journey to implement change:

- **Increasing first-line accountability.** Last year’s survey showed that banks had started this journey, as they were reassessing responsibilities between first and second lines. This has become more widespread this year, with banks going well beyond redefining the principles of first-line accountability for financial and non-financial risks. Banks are making a broader range of changes to achieve effective accountability, including realigning control functions, training the front line on risk, devolving risk appetite further down into business lines and changing incentive structures.

- **Clarifying responsibilities across lines.** A critical component to enhance three-line-model effectiveness is clarifying and communicating the roles of the first and second lines. However, there is no agreed industry template as to which controls should sit in the first or second line. For example, while a clear majority say that their first line performs business-line activity controls, and the second line owns key risk policy, performs control testing and designs the control framework, the industry is split on who performs control monitoring.

- **Firmwide processes and tools underpin an effective three-lines-of-defense approach.** The adoption of common firmwide risk-and-control tools and processes across the three lines is a key component of success. A significant majority of firms have been implementing common risk identification; risk-and-control risk assessments; a process, risk and control taxonomy; and common key-indicator reporting practices. Issues management processes and the underlying technologies remain a challenge. Effective implementation of risk appetite frameworks plays a crucial role in properly reinforcing the three-lines-of-defense approach.

Adapting the structure of risk and compliance functions

Across the first and second lines, the size, focus and effectiveness of risk and compliance groups continues to evolve.

Chief risk officers (CROs) firmly believe their primary contribution to banks’ long-term sustainable profitability lies in linking strategy and risk appetite. This link is essential given the decisions banks are making to evolve their business portfolios, geographic reach, and product and service offerings. Other key roles include identifying aggregate emerging and forward-looking risks, ensuring an effective risk management framework, and helping to influence a firm’s risk culture and behavior.

To achieve these objectives, the vast majority of banks reported increases in risk personnel over the past year, with more to come over the next year. Only a minority of banks plan cuts. Across firms, the compliance function continues to grow along side risk, both in size and stature. Its journey to become more risk-based continues, with some banks establishing more connectivity between compliance and the risk function and a significant proportion moving toward second-line compliance oversight reporting to the CRO.

However, with banks under considerable investor pressure to reduce costs, these functions are being pressed to demonstrate efficiency, while continuing to implement new regulatory requirements and prevent more control failures. Many banks are centralizing particular functions, such as model validation, and stripping out layers, such as divisional or business line CROs. Yet even here, post-crisis regulatory expectations create constraints because of the need to add extra risk layers to meet some new host-country requirements for stronger corporate governance and risk management in local subsidiaries. It is recognized that achieving substantial and material changes in efficiency will require investments in data and systems, but currently it can be challenging to secure funding given economic conditions and industry profitability.
Designing a workable blueprint for managing non-financial risks

The industry, particularly G-SIBs, has struggled with non-financial risks. In aggregate, fines, settlements and remediation costs have run to hundreds of billions of dollars across the industry. The underlying causes relate to weak oversight and controls, lack of first-line accountability, wrong incentives, and IT systems and data weaknesses, among other issues.

Priority risk areas within banks change over time, reflecting regulatory pressure and recent high-profile cases. In prior years, retail conduct was a primary area of concern. While this remains important, money laundering and sanctions have moved further up the agenda for many banks, as have fiduciary and suitability issues.

Banks are applying a broad set of approaches to strengthen their conduct risk management. Many have exited markets, products and geographies, reduced the availability of certain products and services, or limited the complexity of products they offer – all with a view to reducing intrinsic risk.

Banks, especially G-SIBs, have made changes to customer-facing activities, including implementing new rules on how to treat customers and tightening requirements for assessing levels of customer sophistication. Training has been critical,

Board and CRO priorities

The priorities of boards and CROs change, year to year, depending on evolving regulatory expectations, market conditions and industry trends.

Exhibit 1: Top three risk areas for board of directors in the next 12 months

<table>
<thead>
<tr>
<th>Risk Area</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implementation of new regulatory rules and supervisory expectations</td>
<td>50%</td>
</tr>
<tr>
<td>Cybersecurity risk</td>
<td>48%</td>
</tr>
<tr>
<td>Risk appetite</td>
<td>37%</td>
</tr>
<tr>
<td>Firm's culture, behaviors and values</td>
<td>27%</td>
</tr>
<tr>
<td>Credit risk</td>
<td>27%</td>
</tr>
<tr>
<td>Conduct risk, e.g., actions that violate laws or regulatory rules</td>
<td>22%</td>
</tr>
<tr>
<td>Capital allocation</td>
<td>18%</td>
</tr>
<tr>
<td>Stress testing</td>
<td>18%</td>
</tr>
<tr>
<td>Operational risk (excluding cybersecurity risk)</td>
<td>10%</td>
</tr>
<tr>
<td>Risk-technology architecture</td>
<td>10%</td>
</tr>
<tr>
<td>Liquidity risk</td>
<td>8%</td>
</tr>
<tr>
<td>Enterprise risk management</td>
<td>8%</td>
</tr>
<tr>
<td>Recovery and resolution planning</td>
<td>7%</td>
</tr>
<tr>
<td>Reputational risk</td>
<td>5%</td>
</tr>
<tr>
<td>Market risk</td>
<td>3%</td>
</tr>
<tr>
<td>Compensation</td>
<td>2%</td>
</tr>
</tbody>
</table>
as has been the development of enhanced risk assessments, strong first-line accountability for non-financial risks and more use of data analytics.

Respondents identified key ways to better manage non-financial risks, including:

- **A more sophisticated approach to operational risk.** Banks continue to dedicate more resources to operational risk, focusing on unbundling unique risks within this broad category. Cybersecurity ranked as the top area of focus, followed by IT systems and technology risk, and operational failures. Recent enhancements include improving risk assessment and risk identification, processes and controls, business accountability, and data collection. Proposed regulatory changes to operational-risk capital requirements will necessitate more change.

- **A three-lines-of-defense approach to cybersecurity.** This emerged in this year’s survey as one of the most prominent non-financial risks concerning bank boards and CROs. It also garnered more attention in IT, business-line management, internal audit and compliance. Banks are now taking a broad approach to addressing cyber-risks, including adding more dedicated resources to second-line risk and compliance groups and establishing three lines of defense for cybersecurity.
• A move from vendor management to vendor risk management. This issue is in transition – it is no longer simply a procurement concern, but one for risk management. Regulators view vendor risk management as critical for recovery and resolution planning and business continuity, as well as consumer protection. Enhancements are being made to oversight and governance, assessments of vendor information security and business continuity, and the management of inherent risk.

Embedding non-financial risks in other risk-management initiatives

Ultimately, non-financial risks must be deeply embedded into each firm’s ongoing risk management approach. Three key areas stand out in the survey:

• Embedding risk appetite: Firms still struggle to drive risk appetite deep into the operations and to address hard-to-quantify risks in non-financial risk categories. More are developing tailored approaches to quantitative and qualitative elements.

• Driving risk-culture initiatives: Regulators remain focused on firms’ efforts to ensure their culture supports their risk management objectives. Banks realize that there is no silver bullet to strengthening risk culture. They believe that achieving a balance between a sales-driven front-line culture and a risk-focused culture is the number one challenge. Banks are now employing a wide variety of methods, including tone-from-the-top, better communications, enhanced accountability and improved risk reporting.

• Linking culture and performance: Banks recognize that to achieve a strong risk culture – only a quarter of banks claim to have done so – means embedding behavioral criteria into performance evaluations and compensation assessments. As such, beyond implementing regulatory requirements on deferrals, clawbacks, and (in most regions) risk-adjusted, performance-based pay, banks are advancing their approach to embed ethics and control issues into employee pay and performance decisions.

Navigating toward a blueprint for a sustainable, long-term business model

The most challenging aspect of meeting future ROE targets relates to changes required to implement the prudential agenda being driven globally by the Basel Committee on Banking Supervision (BCBS), and locally by regional or domestic regulatory organizations.

The combined capital, liquidity and leverage changes under Basel III have caused banks to rethink their business models. High percentages of both G-SIBs and non-G-SIBs confirmed that they continue to evaluate their asset portfolios, manage customer profitability more actively, shift out of less-liquid financial instruments and exit lines of business.

Banks highlight that the post-Basel III BCBS agenda (what some call “Basel IV”) could have a further impact:

• Substantive change to the internal ratings based (IRB) approach for credit. Banks believe that they will be severely affected by the IRB approach’s proposed changes, especially in countries where corporates rely heavily on bank finance. Removal of large corporate exposures would create capital requirements that could not be remunerated given the spreads these companies would be willing to pay. Many banks believe that introducing floors into the models would adversely affect risk sensitivity, creating distortions and impacting the quality of internal risk information.

• Fundamental review of the trading book (FRTB). The major trading banks are highly concerned about FRTB. The change in required market-risk capital under FRTB could be material and drive further business model changes. How banks respond to FRTB may prove worrisome to policymakers, regulators and other market participants; those responses may include exiting or reduced market-making for certain products such as exotic or longer-dated derivatives and less liquid cash securities. This will pull additional liquidity out of the markets at a time when policymakers are already facing criticism that post-crisis reforms have had too much of a deleterious effect on proper market functioning.

• Other proposals and requirements. The cumulative effects of other proposals – such as those related to the standardized measurement approach (SMA) to operational risk and the net stable funding ratio (NSFR) – could also prove significant.
In the end, the estimated aggregate common equity tier 1 (CET1) capital to cover Basel III, G-SIB requirements and the post-Basel III changes (agreed and expected proposals) is large; 43% of G-SIBs estimated that CET 1 capital will have risen by at least 90% by the time all these requirements have been fully implemented.

A long journey ahead

The industry has made considerable progress in improving its ability to manage risks since the onset of the financial crisis. Boards of directors are more engaged, and risk and compliance functions have greater breadth in scope and seniority. That is the respectable, glass-half-full perspective.

However, the glass-half-empty perspective would say that banks should guard against complacency. It is way too early to claim “mission accomplished.” The challenges ahead are myriad, and any one by itself will require yet more management attention and dedicated resources. Getting the balance right between the first and second lines of defense is critical. Banks also must not forget internal audit. If the first two lines change materially, the third, too, will have to adapt.

Moving past experimenting with new ways to address non-financial risks to embedding concrete, highly tuned practices is a necessity. Finding a stable, sustainable business model in which the amount of capital required by different business and sub-business lines can be adequately remunerated will be a real accomplishment, particularly as the period of regulatory change is certainly not over.

Banks have a solid base of progress on which to move forward. The challenge will be staying the course.
Implementing the blueprint for managing risk more effectively

Rebalancing the first and second lines of defense
The effectiveness of banks’ risk management is an essential element in their ability to achieve sustainable profitability. By managing their risks well, banks can cut profit volatility and reduce the likelihood of reputation damage and costs from conduct remediation and fines.

A core finding of the seventh annual global EY/IIF bank risk management survey is that banks are increasingly focusing on making the first line of defense more aware of their risk control responsibilities and enhancing their ability to perform these responsibilities.

This year’s survey highlights a broader context in which these changes have been taking place. Pre-crisis, many major banks had built up second-line control functions, while the first line (businesses) became mainly focused on revenue generation. In those institutions, first-line accountability for risk was slowly eroded. By contrast, some institutions had a strong culture of first-line accountability, but had not invested enough in the second line. When the financial crisis hit, and the regulatory response kicked in, both types of banks faced considerable pressure to strengthen the three lines of defense.

All banks are now working to make the management of risk everyone’s responsibility. The first line has to manage the risks it creates, both financial and non-financial. The second line has to be fully accountable for enterprise risk. This requires changes in the first or second-line, or both. Commenting on these transformations, a banker said: “What you are seeing is a recognition of ‘I own my risk.’ “

The survey indicates there are several routes to successful risk management. Banks must rebalance roles and responsibilities across and within their three lines of defense, make individual responsibilities clear through the risk appetite and education, ensure there is an appropriate risk culture and make better use of common firmwide processes and technology platforms.

Restructuring the three lines of defense

Post-crisis, regulators in a number of countries concluded that the front line had not been sufficiently engaged in considering intrinsic risks in the business. The survey shows that lack of accountability by the first line has been viewed by G-SIBs as a significant contributory factor to the major conduct-risk failures.

The regulatory response has been relatively consistent globally. Rather than push for a different control philosophy, regulators have since shown a clear preference for a fully functioning three-lines-of-defense model – for example, internationally, in reports from the Financial Stability Board (FSB) and nationally through such requirements as Heightened Standards, from the US Office of Comptroller of the Currency, the Senior Management Regime in the UK and Europe’s Supervisory Review Evaluation Process. The focus from regulators is on individual end-to-end accountability in the first line and on clear independent control functions for all risks.

A global wave of change

Banks are no longer rethinking the framework of a three-lines-of-defense approach. Instead, they are continuing to implement change – recognizing that there is a long road ahead.

Initially, some focused on redefining the principles of accountability for risk. As an executive recalls: “We went back to first principles and the taxonomy of risks, by considering the owner and steward for each risk.” What became clear in many banks was that to discharge their responsibilities, the first line needed more control capabilities and a better understanding of the risks they should own. This led banks to move some control functions to the first line from the second. In one executive’s view: “The first line of defense has to do a bit more and the second line a bit less.” Other banks with perceived weaknesses in managing aggregate risks built out second-line risk and compliance groups further. For some, until recently, this was viewed as an either/or choice. Today, banks recognize that it is all about rebalancing the first and second lines, such that both are fully able to perform their roles, supported by the third line, internal audit.

Not all banks are at the same point in the process of implementing change. The majority still feel they have work ahead, with 60% of all responding banks (52% of G-SIBs and 64% of non-G-SIBs) saying they are still in the process of changing their three lines of defense. The scale of change varies by institution. As one respondent said: “Did we fundamentally change our approach? No. Did we work to clarify some areas that needed clarification? Yes.” Such change, inevitably, will be felt across all three lines over time.
“The board and the risk function see that there is a fair bit of industry anguish about the three lines of defense, but we realize how important it is to have three lines – and for everyone to be doing their job well.”

— Banking executive

Multiple factors are driving these changes, as shown in Exhibit 3.

### Increasing first-line accountability

Last year’s survey presented clear evidence that banks had started to make changes to strengthen first-line accountability for risk. This trend has accelerated over the past year, with banks adopting a broader range of changes to drive accountability – as one banker put it, “We use all possible levers.”

- Nearly three-quarters of respondents were providing the first line with training on risk, as well as clarifying first-line responsibilities for risk appetite.
- About half were establishing new control functions in the first line and increasing their focus on forward-looking risk.
- Approximately one-third changed the accountability of business-line heads to make their risk responsibilities clearer.

Strengthening first-line accountability will take time and require a re-education of those in the business units. The second line has to support the first line. “We are making more tools and information available to the first line to support them in making decisions,” said one executive.

Banks have been strengthening their first lines to better manage non-financial risks, and identified critical factors to delivering first-line accountability (see Exhibit 4).

- Among G-SIBs, 63% listed increasing first-line accountability as an action they were taking to reinforce conduct risk management.
- Given options for how management would control costs going forward, 81% – the biggest proportion, by far – cited improving the capabilities of first-line personnel to control conduct risk.
- Enhancing first-line policies was cited by 62% as an area where they expected management to invest to help control conduct risk.

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Exhibit 3: Banks are changing their three lines of defense for many reasons

- **Overall**
  - To make the first-line accountable for end-to-end risk: 38%
  - To make the first-line accountable for non-financial risk: 28%
  - To make the first-line accountable for financial risk: 27%
  - To create fully independent second-line functions: 14%
  - To make the first-line accountable for some non-financial risks such as conduct: 18%
  - To enhance the role of internal audit: 7%

- **G-SIB**
  - End-to-end risk: 33%
  - Non-financial risk: 29%
  - Financial risk: 33%
  - Fully independent second-line functions: 23%
  - Some non-financial risks: 18%
  - End-to-end accountability: 13%
  - Internal audit: 10%

- **Non-G-SIB**
  - End-to-end risk: 41%
  - Non-financial risk: 29%
  - Financial risk: 28%
  - Fully independent second-line functions: 23%
  - Some non-financial risks: 28%
  - End-to-end accountability: 27%
  - Internal audit: 23%
“The first line must understand risks and recognize that risk is not always where it is believed to be – and must apply controls for their own health.”

– Risk executive

### Changes to reporting lines in risk functions

CRO structures vary depending on the complexity of the firm. The most prevalent structure noted by respondents – 43% of G-SIBs and 37% of non-G-SIBs – was a primary reporting line to functional heads within the group risk function who report to the group CRO, with secondary reporting lines to the CROs at the business-line, regional and legal-entity levels.

Given the burden on firms to boost their ROE, risk functions are struggling to reduce or contain costs. Some have stripped out layers such as divisional CROs and centralized functions, for example, model validation. However, pressure from regulators to enhance subsidiary governance in several jurisdictions is adding to layers in some areas.

### Exhibit 4: Important factors for first-line risk accountability

<table>
<thead>
<tr>
<th>Factor</th>
<th>Average Ranking</th>
<th>1 = Most Important</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6 = Least Important</th>
</tr>
</thead>
<tbody>
<tr>
<td>First-line risk management skills and capabilities</td>
<td>2.6</td>
<td>28%</td>
<td>30%</td>
<td>20%</td>
<td>15%</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>Having the right incentives in place</td>
<td>3.2</td>
<td>27%</td>
<td>9%</td>
<td>16%</td>
<td>18%</td>
<td>24%</td>
<td>6%</td>
</tr>
<tr>
<td>Clearly defined processes and activities</td>
<td>2.6</td>
<td>20%</td>
<td>35%</td>
<td>20%</td>
<td>20%</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Group risk appetite allocated at a business line</td>
<td>3.5</td>
<td>18%</td>
<td>14%</td>
<td>16%</td>
<td>18%</td>
<td>23%</td>
<td>11%</td>
</tr>
<tr>
<td>Control capability in the first line</td>
<td>3.5</td>
<td>7%</td>
<td>12%</td>
<td>30%</td>
<td>26%</td>
<td>23%</td>
<td>2%</td>
</tr>
<tr>
<td>Moving some risk management activities from the first to the second line</td>
<td>5.5</td>
<td>2%</td>
<td>2%</td>
<td>16%</td>
<td>77%</td>
<td>0%</td>
<td></td>
</tr>
</tbody>
</table>

[1 = Most Important | 2 | 3 | 4 | 5 | 6 = Least Important]
Adapting the structure of risk and compliance functions

Across the first and second lines, the size, focus and effectiveness of risk and compliance groups continues to evolve.

Risk function plays a critical role linking strategy and risk

The risk function contributes to banks’ long-term sustainable profitability in a number of ways. Survey respondents named these as the most significant:

- Linking strategy and risk appetite (cited by 72%)
- Identifying aggregate emerging and forward-looking risks (57%)
- Ensuring an effective risk management framework (47%)
- Helping influence firm risk culture and behavior (45%)

The link to strategy is critical given the emphasis regulators have placed on managing strategic risk more effectively and having a robust strategic planning process that links to capital, liquidity, and recovery and resolution. It also highlights risk’s essential input into decisions to evolve the banks’ business portfolio, geographic reach, and product and service offerings. Risk functions need to assess how far risk appetite is embedded in business decisions – an area where the industry recognizes that more needs to be done.

Banks are still finding it hard to meet these objectives without adding more risk personnel to the first and second lines. In fact, they are doing so more aggressively than ever: 55% and 40%, respectively, reported that their risk headcount had risen in second- and first-line risk in the past year. With aspirations to reduce costs, 15% reported a decline in risk personnel, compared with 8% in each of the two previous years. However, the upward trend will likely continue overall, as the majority of firms expect to add more professionals to headcount in the next year.

One clear message from interviews with senior risk leaders was that regulatory change continues to drive headcount increases in risk functions of some banks, with no sign of abatement given changing regulatory requirements. Another message was that achieving greater efficiency will require significant spend on IT and data, particularly sourcing data straight through from the front office. However, banks are finding it difficult to find the necessary budgets in the short term, given that these projects have longer-term payoffs.

“The business lines are enhancing the control environment by investing in people to be more dedicated to product controls and performance, operational and legal risks.”

— Banking executive

Exhibit 5: Description of reporting lines for the risk function

<table>
<thead>
<tr>
<th>Reporting Line Description</th>
<th>Overall</th>
<th>G-SIB</th>
<th>Non-G-SIB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary reporting line to functional heads within the group risk function who report to the group CRO, with secondary reporting lines to business line (divisional) CROs/region CROs/legal entity CROs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary reporting line to business line CROs who report to the group CRO with secondary reporting lines to functional heads within the group risk function</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary reporting line to functional heads within the entity risk function who report to the entity CRO who reports to the group CRO</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary reporting line to functional heads within the regional risk function who report to the region CRO who reports to the group CRO, with secondary reporting lines to business line CROs and legal entity CROs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>14%</td>
<td></td>
<td>29%</td>
</tr>
</tbody>
</table>

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Compliance function is becoming more risk-oriented

Compliance groups are on a journey, following major control failures. There is a greater focus on the need to have a clear second line to review compliance risks. Showing commitment to the importance of the compliance function, many have altered reporting structures for chief compliance officers (CCOs) in an effort to enhance the CCO’s stature. As an executive explained, “With the CRO and CCO having the same power and responsibility, the second line has been empowered by the board.” Few CCOs report to the head of legal anymore, while 73% of responding firms say that their CCOs report to the CEO or CRO (see Exhibit 6). This is part of banks’ reconfiguration of their three lines of defense, driven by regulatory pressure for compliance to have a fully independent role within the firm.

In interviews, a number of bank executives noted that the reporting lines are part of a broader shift toward a more risk-based and less legalistic mindset. More recently, some firms have been determining how to better align compliance and operational risk groups or to strengthen compliance oversight at the board level, and seeking ways to use more consistent tools and frameworks across these groups where possible. However, some banks said that although compliance needs to become more risk-focused, in their institutions, the staff still largely has a legal mindset; these banks are not as far along the change journey as others.

Exhibit 6: Most chief compliance officers report to the CEO or CRO

The compliance function continues to grow alongside risk. Almost four in five (78%) banks surveyed indicated that the number of compliance people increased in the last 12 months, and about two-thirds (65%) expect further increases in the next 12 months. A small minority of G-SIBs (14%) expect to decrease compliance in the year ahead.

Clarifying responsibilities across lines

A critical component of enhancing the effectiveness of the three-lines model is clarifying and properly communicating the roles of the first and second lines.

No industry standard on where roles should reside

Given the evolution taking place in roles and responsibilities, views differ across the industry as to what should be done by the first or second line. Four in five (80%) respondents say that their first line performs business-line activity controls, while 80%-90% say that their second line owns key risk policy, performs control testing and designs the control framework. The industry is split on who performs control monitoring, with 49% and 51% placing it in the first and second line, respectively.

Across the industry, however, there is greater agreement on where risk activities should take place in the corporate/institutional business and the small-business/retail side. Generally, the first line owns these activities for the corporate/institutional businesses, whereas the majority say that the second line owns them for small-business/retail businesses (see Exhibit 7).

Clarifying, communicating and training against roles and responsibilities is challenging. Increasingly, firms are using governing principles to drive change. In the past two years, 55% of responding banks have redefined their governing principles and, of those, 91% say that this redefinition has resulted in operating-model changes that facilitate greater first-line accountability for risk. Inevitably, as roles and activities change in the first and second line, the third line—internal audit—also will be affected eventually.
Similarly, firms have been focusing on how best to conduct testing, e.g., model validation or compliance processes, in the first or second line. Over the years since the crisis, testing functions have sprung up across the lines, with little, if any, effort to ensure consistency or have the work performed efficiently. This is changing. About a third (32%) of firms have already created a centralized testing team, and more (37%) have established central teams for some aspects of testing. Almost a fifth (19%) more believe in such an approach, but are either unsure how best to do it or are still in the planning stage. Only 12% said they had no intention of doing so.

Firmwide processes and tools underpin an effective three-lines-of-defense approach

Alignment on roles across and between the three lines of defense may be critical, but so, too, is the adoption of common firmwide risk-and-control tools and processes.

Respondents cited several factors driving a clear trend toward firmwide approaches (see Exhibit 8). However, these vary by region. For example, regulatory pressure is driving banks...
most prominently in Europe, where it was cited by 53% of respondents, which is far more than in Africa/Middle East, Asia-Pacific, Latin America and North America. In contrast, North American banks were much more likely (77%) to cite the desire to better leverage risk assessments across the firm as a driver compared with other regions.

The adoption of firmwide approaches is not uniform across the industry. Many firms have fully or mostly implemented common risk identification (95%); risk-and-control risk assessments (92%); a process, risk and control taxonomy (81%); and common key-indicator reporting practices (70%). These are key foundational elements of a common approach.

Issues management processes remain a challenge, in part because of suboptimal governance-risk-and-control system implementation. Indeed, a large majority of respondents have not started or only partially begun implementing common data-analytic processes (63%) and technology platforms (60%).

Firms’ journeys to implement risk appetite frameworks properly – driving them down into the operations and addressing non-financial risks – also play a crucial role in reinforcing the three-lines-of-defense approach. Firmwide risk culture initiatives are important. As one respondent explained: “Risk appetite and risk culture are the big thematic endeavors that help the first line wake up to their responsibilities so they are willing to invest in the [necessary] capabilities.” Training is central to these efforts, with 72% providing training to the first line to enhance accountability and 71% improving training to better control conduct risks.

**The bottom line: risk and control structures will remain a challenge for banks**

Risk management structures continue to evolve as banks seek the most effective balance of roles and responsibilities across their three lines of defense. Getting the first line fully engaged in managing risks, including conduct risks, is essential, but changes are needed in other areas, such as incentives and risk appetite accountability. Greater ownership by the businesses of risks attached to individual decisions will make the second-line control of aggregate risk more effective.

However, banks know they cannot simply keep adding headcount to better manage risk. In some areas, this may be necessary – for example, to properly staff controls in the first line or better manage non-financial risks in the second line. But depressed bank profitability will not support such a simplistic approach, long term. Common firmwide approaches, better technology and more advanced data analytics are essential, as are properly implemented centralized teams for common, repeatable tasks, such as testing. Getting these right will allow firms to depend less on headcount and more on standardized, dependable techniques and processes. Ultimately, that is the only way to deliver the right risk outcomes cost-effectively.
“Rather than increase the number of people in the second line, it would be more efficient to enhance systems and data, and more clearly define roles.”

– Banking executive
Developing a working blueprint to address non-financial risks
Moving beyond experimentation
Managing non-financial risks more effectively has become a dominant issue for many banks, particularly G-SIBs. These risks — particularly conduct risks — have cost the industry dearly, as evidenced by the billions of dollars in fines, settlements and remediation costs paid in recent years. Banks now firmly recognize that they need the management of risk to be part of everyone’s job, not just those in risk and control roles. Under relentless pressure from multiple sources — regulators, lawmakers, investors and other stakeholders — banks are testing and enhancing controls and control frameworks.

Banks recognize that better identification and management of intrinsic risk is needed. But, without a clear blueprint on how to identify, measure, monitor and mitigate non-financial risks, banks have greatly increased the level of experimentation across the industry on how to do so, even compared with last year. The seventh annual global EY/IIF bank risk management survey highlights these developments, which are akin to attempts to measure and later quantify credit risk, some 30 years ago.

Many banks now know that an important step is shifting from measuring operational risk just using the Basel-type combined loss-driven “operational risk” category to using various approaches for different non-financial risks. However, some confusion remains, in part because of overlapping terminology used across the industry. Definitions of non-financial risks, conduct risks, and operational risks overlap significantly, as does the term “misconduct risk” used by the FSB. Getting past this confusion will be important for progress.

The importance of managing non-financial risks

The industry, particularly G-SIBs, has struggled with non-financial risks. In the past five years, 51% of G-SIBs reported losses, including fines, settlements and remediation costs, of at least US$1 billion, with 6% reporting losses of at least US$20 billion (see Exhibit 9). G-SIBs are under much more pressure in this regard than other banks, reflecting their size and global reach: the largest loss among non-G-SIBs was US$500 million to US$1 billion, reported by just 8% of non-G-SIBs.

Not surprisingly, the drivers of these costs differ across the two categories of banks. G-SIBs were more likely to attribute losses to conduct issues (behavior toward customers or in markets) in retail and wholesale markets, along with failures of financial crime and money laundering controls. By contrast, non-G-SIBs cited operational failures most often.

The underlying causes also differ. All banks cited weak oversight and controls as the top cause and listed a lack of first-line accountability in their top five causes. However, G-SIBs highlighted changes in the regulatory environment, wrong incentives and weaknesses in risk transparency as the other major drivers. Non-G-SIBs, by contrast, point to IT system and data weaknesses and lack of training.

The priority areas of focus change over time, reflecting more recent high-profile control failures and emerging regulatory and public concerns. In prior years, retail conduct was a primary area of concern, for example, in countries such as Australia, the UK and the US. More recently, in light of high...
fines and threats of the removal of operating licenses, banks now put money laundering and sanctions even higher up the list — 72% of banks mentioned money laundering as one of their highest risks, up from 52% last year, and 52% cited sanctions, versus 30% last year (see Exhibit 10). A heightened focus on fiduciary and suitability issues also comes through in the survey, reflecting increased emphasis by some regulators.

Significant focus on conduct risks

Banks are applying a broad set of approaches to strengthen their management of conduct risks, underscoring their high level of exposure to such risks, as well as the sheer complexity of these issues. As yet, there is an absence of industry-wide consensus as to the most effective strategy to address these risks.

Many banks have made strategic decisions to exit markets, products and geographies, or to reduce the availability of certain products and services, in part to reduce intrinsic risks as a way of managing conduct risks. They have reduced the complexity of the products they offer. Reflecting the views of other bank leaders, one risk executive said there was an ongoing focus on the “simplification of products, making statements clearer, with fewer complex products and fewer options.” Banks making these changes have typically concluded that heightened conduct risks are just too hard to manage.

For the most part, G-SIBs have been more active than non-G-SIBs in making changes to customer-facing activities, reflecting the consumer protection failures they have experienced in recent years. G-SIBs have been especially focused on training, implementing new rules on how to treat customers, tightening requirements for assessing customers' sophistication and embedding new escalation processes for the mistreatment of customers.

**Exhibit 10: In conduct risk, money laundering and sanctions have moved up the agenda**

<table>
<thead>
<tr>
<th>Risk Category</th>
<th>2016 Overall</th>
<th>2015 Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money laundering</td>
<td>79%</td>
<td>72%</td>
</tr>
<tr>
<td>Retail product mis-selling</td>
<td>53%</td>
<td>60%</td>
</tr>
<tr>
<td>Not meeting fiduciary obligations or suitability standards</td>
<td>58%</td>
<td>55%</td>
</tr>
<tr>
<td>Sanctions</td>
<td>41%</td>
<td>74%</td>
</tr>
<tr>
<td>Market abuse</td>
<td>28%</td>
<td>41%</td>
</tr>
<tr>
<td>Unauthorized trading</td>
<td>37%</td>
<td>40%</td>
</tr>
<tr>
<td>Financial advice</td>
<td>16%</td>
<td>28%</td>
</tr>
<tr>
<td>Tax advice</td>
<td>10%</td>
<td>14%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>G-SIB and Non-G-SIB</th>
<th>2015 Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>G-SIB</td>
<td>52%</td>
</tr>
<tr>
<td>Non-G-SIB</td>
<td>70%</td>
</tr>
</tbody>
</table>

* Not listed in 2015
Across the industry, banks have been using a broad range of measures to address conduct risks (see Exhibit 11 and Exhibit 12).

Accountability for non-financial risks has been a major focus. Without question, banks are pushing for first-line accountability. However, functionally, accountability for areas such as conduct risk is shared by CCOs (68%), CROs (63%), or heads of operational risk (44%). Training is important, especially in terms of ensuring everyone understands their role in managing risk. Banks are now training first-line staff not just on their responsibilities, but also on the risks. One bank interviewed spoke of the rest of the business now attending the same training as their risk professionals.

Banks are adopting differing approaches to embedding conduct risks within their risk taxonomy. Almost half (45%) treat it as a theme that cuts across risk types. However, 38% integrate it as part of their operational risk taxonomy, while 17% view it as a distinct and separate risk type. What matters most is being able to link together a range of specific non-financial risks to enable reporting to the board, senior management and regulators. Greater use of data analytics and more sophisticated scorecards are needed.

Other top areas of focus for managing non-financial risks

The range of change and innovation in managing non-financial risks can be seen in three areas:

- Operational risk
- Cybersecurity
- Vendor risk

Banks continue to improve their approach to operational risk

Banks have increased their attention to operational risk and improved their approaches to managing it. In fact, 77% of respondents said that their firms devoted more time and resources to operational risk in the past year, with another 22%...
Banks are enhancing their management of operational risk using a broad range of techniques, including:

- Improving risk assessment and risk identification processes (63%)
- Enhancing processes and controls generally (53%)
- Enhancing business accountability (41%)
- Improving data collection (34%)
- Improving personnel capacity and capabilities (32%)

devoting the same amount of time as in the past. This is in line with the general trend of shifting from managing such risks in line with the Basel operational risk definition: “the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.”

Banks are focusing on a number of such component risks, some of which overlap with those that have been more recently relabeled as conduct risks (see Exhibit 13).
**Cybersecurity surges in importance for boards and CROs**

Given the rising incidence of cyber attacks on financial institutions, cybersecurity emerged in this year’s survey as one of the biggest non-financial risks for bank boards. Almost half (48%) of respondents highlighted cybersecurity as one of the three most important risks for their board over the next year, with only the implementation of new regulatory rules and supervisory expectations being more important.

Cybersecurity has shot up the CRO agenda. It ranked second (51%) in the list of top five concerns over the coming year, up from 22% and 10%, respectively, in 2015 and 2014. Within the context of operational risk, cybersecurity ranked as the top (89%) area of focus, followed by the related IT systems and technology risk (72%).

Numerous other bank functions or governance groups have increased their focus on cybersecurity in the past year, including IT (cited by 93%), business-line management (71%), internal audit (66%) and compliance (42%).

---

**Exhibit 13: Areas of particular or enhanced focus on operational risk**

<table>
<thead>
<tr>
<th>Area</th>
<th>Focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cybersecurity risk</td>
<td>89%</td>
</tr>
<tr>
<td>IT systems and technology risk</td>
<td>72%</td>
</tr>
<tr>
<td>Operational failures</td>
<td>67%</td>
</tr>
<tr>
<td>Third-party vendor risk</td>
<td>54%</td>
</tr>
<tr>
<td>External fraud, e.g., credit card fraud</td>
<td>50%</td>
</tr>
<tr>
<td>Business continuity disruptions</td>
<td>50%</td>
</tr>
<tr>
<td>Reputational risk</td>
<td>43%</td>
</tr>
<tr>
<td>Model risk</td>
<td>41%</td>
</tr>
<tr>
<td>Conduct issues (retail products)</td>
<td>37%</td>
</tr>
<tr>
<td>Conduct issues (markets)</td>
<td>35%</td>
</tr>
<tr>
<td>Conduct issues (wholesale products)</td>
<td>35%</td>
</tr>
<tr>
<td>Internal fraud, e.g., unauthorized trading or other such activity</td>
<td>24%</td>
</tr>
</tbody>
</table>

“With the pace of change in technology and regulatory over the next five years, it seems more likely that the future CRO might be more of a technology person than a credit person.”

— Bank executive
A set of blueprints for success

A risk officer, put this shift into perspective. “It is very hard to mitigate for risks from our vendors, as we don’t control them,” he said. “It is hard to verify that what they say they are doing, they are actually doing.”

Embedding non-financial risks in other risk-management initiatives

Ultimately, non-financial risks have to be firmly embedded into the firm’s ongoing risk management approach and linked to key human-resource processes. Over the last year, this has been visible in three areas: further embedding non-financial risks into risk appetite, driving forward risk-culture initiatives, and linking culture and performance.

Further embedding non-financial risks into risk appetite

Regulators are increasingly demanding risk appetite frameworks be much more effective, such that fewer firms this year thought that they had successfully communicated, embedded and enforced them in their organization (40% this year versus 43% last year). Embedding them into operations
(72%) and expressing risk appetite for certain risks that are hard to quantify (65%) remain clearly the most difficult challenges.

The latter issue points to the importance of better incorporating non-financial risks. Even more banks are creating a risk appetite approach for these risks than last year (93% from 83%). Most (60%) have developed a tailored approach to cover the quantitative and qualitative elements, and almost half (47%) have allocated operational-risk losses to business lines.

**Driving forward risk-culture initiatives**

Regulators remain focused on firms’ efforts to use their culture as a risk management tool. This was particularly true for G-SIBs, whose respondents said that several items – notably risk appetite, risk behaviors, compensation and various control processes – were under the regulatory microscope in this context.

Banks realize that there is no silver bullet to strengthening risk culture. They cited several key reasons for breakdowns in culture:

- Conflict between a sales-driven first-line culture and the firm’s risk culture (cited by 49%)
- Lack of first-line risk accountability (44%)
- Too great a focus on meeting targets (42%)
- Profit and market share pressure (42%)

To address these issues, banks are employing a wide variety of methods. Of the many ways listed in this year’s survey, 12 are being used by at least 30% of respondents (see Exhibit 15).

**Linking culture and performance**

Immediately after the financial crisis, policymakers and regulators focused on compensation, notably on deferrals, clawbacks and (in some regions) the magnitude of performance-based pay. In many ways, this focus continues.

However, banks recognize the challenge goes beyond the structure and magnitude of pay. They are starting to embed ethics and control issues more broadly into employee pay and performance decisions, with a shift toward focusing on all professional staff rather than just business heads.

Of note in this year’s survey, banks have:

- Widened the application of metrics linking pay to risk and compliance: 40% of respondents used such metrics for all professional staff, 17% for business-line heads and 24% for direct reports of business-line heads.
- Revised performance metrics of business-line heads to better incentivize them to drive risk-compliant behaviors and to reinforce accountability, especially for non-financial risks. In fact, 82% of respondents made such revisions in the last two years, including 30% in the past year.
- Increased the degree to which bonuses are automatically reduced for employees who breached controls: this year, 55% had some type of automatic reduction in pay or bonus pools, up from 50% last year. Now, 29% have an automatic link between control breaches and bonuses, up from 17% in last year’s survey. Last year, more firms limited such deductions to significant control breaches.

The future: still a work in progress

Clearly, banks are going to great lengths to better manage non-financial risks. They have no choice: breaking the cycle of costly misconduct is crucial to their long-term sustainable growth. This task is much easier said than done, however. While the survey results show how much the banks are experimenting, they reveal how elusive success remains after years of trying to find enduring solutions.

Whether measuring and monitoring conduct or operational risk, enforcing compliance or dealing with the emerging threat of cybersecurity, banks still have plenty of work ahead of them. They are continuing the search for a blueprint to managing their non-financial risks and embedding them successfully into their risk appetites and risk culture.
“We are spending a great deal of time and focus on culture and ensuring that the basic values of employees are strengthened.”

– Bank executive

Exhibit 15: How organizations are strengthening risk culture and employee behavior

<table>
<thead>
<tr>
<th>Action</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enhancing messages and tone from the top</td>
<td>90%</td>
<td>75%</td>
</tr>
<tr>
<td>Enhancing communication and training regarding risk values and expectations</td>
<td>83%</td>
<td>71%</td>
</tr>
<tr>
<td>Embedding risk appetite more consistently across the organization</td>
<td>67%</td>
<td>81%</td>
</tr>
<tr>
<td>Strengthening accountabilities in the three lines of defense</td>
<td>65%</td>
<td>21%</td>
</tr>
<tr>
<td>Making business-line heads much more accountable for risk, including conduct</td>
<td>57%</td>
<td>35%</td>
</tr>
<tr>
<td>Aligning compensation with risk-adjusted performance metrics</td>
<td>53%</td>
<td>63%</td>
</tr>
<tr>
<td>Enhancing risk management frameworks</td>
<td>53%</td>
<td>48%</td>
</tr>
<tr>
<td>Improving risk information and transparency</td>
<td>43%</td>
<td>46%</td>
</tr>
<tr>
<td>Establishing or enhancing ethics codes/committees</td>
<td>42%</td>
<td>*</td>
</tr>
<tr>
<td>Improving broad performance measurement, including promotion</td>
<td>32%</td>
<td>19%</td>
</tr>
<tr>
<td>Implementing new or enhanced new-product-approval process</td>
<td>30%</td>
<td>*</td>
</tr>
<tr>
<td>Changing treatment of control breaches to reinforce need for compliance</td>
<td>30%</td>
<td>*</td>
</tr>
<tr>
<td>Changing the incentive structure</td>
<td>27%</td>
<td>*</td>
</tr>
<tr>
<td>Changing compensation to reflect softer cultural issues</td>
<td>23%</td>
<td>31%</td>
</tr>
</tbody>
</table>

* Not listed in 2015
Finding a strategic blueprint
Increasing ROE while boosting capital levels
Banks are caught in a bind. Economic conditions and low interest rates are dampening profitability, and regulators are still pushing their regulatory agenda to require yet more capital on top of the Basel III changes to date — all of which are putting downward pressure on the ROE. Although this move was not designed to increase the overall capital requirements, it may do so. On the other side, investors are not accepting lower ROEs and are pressuring banks to boost returns.

The seventh annual global EY/IIF bank risk management survey finds that this challenging combination, which one banker called a “toxic mix,” means that banks need to change their business models, geographic reach, and product and service offerings — a trend that is likely to increase as the post-Basel III agenda comes into force.

Banks are working through these changes so they can reach a period of stability to address the business model changes needed and settle on new strategies. However, the continued reforms coming from the BCBS make this difficult. Ongoing changes to regulatory implementation timelines, and variations in actual country-level requirements, exacerbate the situation. Many banks see the current set of proposed changes as potentially highly damaging to traditional banking models.

Industry convergence on 10%-15% ROE targets for next three years

Banks are under tremendous investor pressure to deliver strong, sustainable ROEs. Target ROEs have come down considerably in the aftermath of the financial crisis and the prospects for future increases are weak. Many banks have a cost of capital that is just below, or in some cases just above, actual ROEs.

Nearly four in five responding banks say that their investors are pushing for higher ROEs (82%) and reduced costs (79%). More than half (52%) of G-SIBs say their investors are demanding changes in their business mix or further deleveraging, notwithstanding the fact that many have already made significant changes of this kind.

In this context, banks seem to be converging on industry norms of three-year ROE targets of 10%-15%; 57% of banks cited this target this year, compared with 49% last year. The convergence can be seen across G-SIBs and non-G-SIBs. Last year, 13% and 40% of G-SIBs and non-G-SIBs, respectively, were promising 15% or higher ROEs to their investors; this year, only 5% and 34% are doing so. However, some banks that were targeting lower ROEs last year have increased targets to 10%-15% this year in response to investor pressure (see Exhibit 16).

Achieving these targets will require banks to make tough decisions

Executives know that, while these ROE targets are much lower than pre-crisis levels, achieving them will prove difficult. Banks are struggling to drive up ROEs given the heavy investments they are making to further strengthen their risk and compliance groups and support first-line accountability for risks.
Moves to rely more heavily on data analytics, automated processes and common firmwide risk and control approaches will help ameliorate costs in the long run. But, those initiatives are competing for budgets against other investments to transform business models and gain efficiencies. Intensifying competition from FinTech and shadow banking further limits available funds as opportunities to increase prices and revenue are constrained.

Basel III proposals have a considerable impact

The most challenging aspect of meeting future ROE targets relates to the changes needed as a result of implementing the prudential agenda being driven globally by the BCBS and local regulators.

The combined capital, liquidity and leverage changes under Basel III have led banks to rethink their business models (see Exhibit 17). A large percentage of both G-SIBs and non-G-SIBs confirmed that they are continuing to evaluate their asset portfolios, more actively manage profitability, shift out of less-liquid financial instruments and exit lines of business. Few banks are immune from these effects. As one executive put it: “Capital regulation is a huge driver of business model change.”

There are signs that the scale of strategic change from Basel III is slowing, at least for the largest banks. The percentage of banks evaluating their asset portfolios, while still high at 77%, has decreased from 87% in 2015. Overall, 69% of banks say they are mostly or substantively complete in implementing changes induced by Basel III.

However, if anything, the more difficult decisions remain. One executive described the detailed analysis his firm made in light of Basel reforms: “We undertook a massive exercise across many levels – business units, products, transactions – desk by desk – to allocate [the fully loaded capital cost], so we could properly determine the mix of business and clients we want.” Inevitably, to be useful, such analysis has to be very granular and lead to important, albeit targeted, decisions.

Exhibit 17: Basel III will lead to changes in business models

<table>
<thead>
<tr>
<th>Change in Business Models</th>
<th>G-SIB</th>
<th>Non-G-SIB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evaluating asset portfolios</td>
<td>67%</td>
<td>77%</td>
</tr>
<tr>
<td>More actively managing customer profitability</td>
<td>57%</td>
<td>81%</td>
</tr>
<tr>
<td>Shifting out of complex, less liquid instruments</td>
<td>49%</td>
<td>52%</td>
</tr>
<tr>
<td>Exiting lines of business</td>
<td>40%</td>
<td>62%</td>
</tr>
<tr>
<td>Streamlining legal entity structures</td>
<td>17%</td>
<td>52%</td>
</tr>
<tr>
<td>Exiting geographies</td>
<td>17%</td>
<td>43%</td>
</tr>
</tbody>
</table>
Bank responses also highlighted other requirements that are not yet fully implemented:

- **NSFR.** Most banks believe that they can raise the stable funding required to meet the NSFR. However, a significant minority – 26% of G-SIBs and 20% of non-G-SIBs – still see challenges in doing so. This could constrain some longer-term lending in the future, either because sufficient stable funding is not available or the costs are too high.

- **TLAC.** Most banks have addressed their total loss absorbing capital (TLAC) needs. Among G-SIBs, 47% have issued bonds that they think will be TLAC-compliant, 32% plan to issue new bonds and 21% do not; 66% of non-G-SIBs reported that they were not planning to issue such instruments.

**“Basel IV” will put further pressures on banks**

Banks highlight that the so-called “Basel IV” agenda could have a very negative impact, especially on G-SIBs. Proposals related to the standardized floors for IRB approaches and SMA for operational risk could substantially affect banks, according to respondents. FRTB will affect capital, infrastructure, and business strategy at leading banks, as well as the market in general.

**IRB approaches will curtail bank funding to corporates**

IRB proposals are of major concern to banks. They emphasized that corporate lending would suffer if the proposal to remove large corporate loans from the IRB approaches proceeded. This would particularly affect banks in regions where large corporates are much more dependent on bank finance, for example, Europe. Corporate lenders will not be willing to pay sufficient margins to remunerate the high capital charges demanded by the standardized approach.

Proposals to include various floors on risk parameters in models for the IRB approach to capital requirements for credit risk are also causing concern among banks, because of the reduction in risk sensitivity. Among G-SIBs, 71% thought such floors would affect the economics of certain business lines, 67% thought the floors on IRB would affect risk pricing, and 33% expressed concern about the quality of banks’ risk information. Non-G-SIBs were less concerned, with 43% believing that floors would not affect risk pricing or risk information (see Exhibit 18).

Bank leaders expressed real concerns. One risk executive said the movement of large volumes of exposures to standardized approaches would be a “tremendous effort” and “change the rules of the game.”

**Exhibit 18:** The reduced risk sensitivity of IRB models will impact business

<table>
<thead>
<tr>
<th>Impact</th>
<th>Overall</th>
<th>G-SIB</th>
<th>Non-G-SIB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Could change the economics of some areas of business (e.g., business models)</td>
<td>63%</td>
<td>71%</td>
<td></td>
</tr>
<tr>
<td>Affects risk pricing</td>
<td>57%</td>
<td>67%</td>
<td></td>
</tr>
<tr>
<td>Impacts the quality of risk information within the bank</td>
<td>53%</td>
<td>67%</td>
<td></td>
</tr>
<tr>
<td>Will not have an effect because separate models are run for internal risk information</td>
<td>33%</td>
<td>33%</td>
<td>33%</td>
</tr>
<tr>
<td>Will not affect risk pricing because other parameters will be used for pricing models</td>
<td>16%</td>
<td>23%</td>
<td>20%</td>
</tr>
</tbody>
</table>
SMA for operational risk will impact capital

Banks highlighted that the SMA for operational risk will drive up capital, especially for G-SIBs – with 67% and 19% of them respectively, expecting a significant or moderate increase. However, G-SIBs are relatively positive on the impact of this proposal in promoting global consistency and transparency on operational-risk capital levels: about two-thirds (67%) believe it will moderately or significantly help achieve these goals.

FRTB will drive change

Investment and trading banks will be significantly affected by FRTB. Banks are at varying levels of preparedness to implement the FRTB market-risk framework. Not surprisingly, G-SIBs are furthest along in this process; at the time of completing this survey, 37% reported that their FRTB preparations were under way, compared with 28% of non-G-SIBs. Indeed, 21% of G-SIBs, compared with 8% of non-G-SIBs, have started to implement elements of their strategic solutions to some degree.

Firms have already identified a range of expected implementation challenges. G-SIBs are most concerned about computing power, data and governance requirements, as shown in Exhibit 19.

The change in required market-risk capital under FRTB proposals, as viewed by our survey participants from April to July 2016, could be significant, with 77% of the banks expecting an increase; 68% of G-SIBs and 52% of non-G-SIBs anticipate an increase of more than 30% (see Exhibit 20). One executive concluded: “Certain trading businesses will not be as profitable as a result of the trading book reforms.”

Exhibit 19: Computing, data quality and testing present the greatest FRTB implementation challenges
The likely actions that banks will take in response to FRTB may lead to another fall in market liquidity, which could prove worrisome to policymakers and other market participants (see Exhibit 21). New requirements may lead banks to withdraw from exotic and long-dated derivative markets and markets for less liquid cash securities, and maintain smaller inventories. Reduced market-making activities would likely exacerbate market volatility and make it harder for customers and dealers to rebalance positions in difficult times. Reduced liquidity may also lead to higher spreads, which will further drive down liquidity. In interviews, banks stressed that the loss of some hedging instruments was material but was unavoidable because the capital required could not be remunerated.

**A significant cumulative effect**

It is still difficult to fully estimate the combined effect of all requirements and the interplay with accounting changes. However, even after already changing their business models significantly, banks will have to make more changes going forward. The estimated aggregate CET1 capital to cover Basel III, G-SIB requirements and the changes post-Basel III (agreed and expected proposals) will bring extra urgency to such changes: 21% of banks, including 43% of G-SIBs, estimated that CET1 capital will have risen by at least 90% by the time all the requirements have been implemented (see Exhibit 22). However, much of the effects of Basel III and the G-SIB surcharge have already been absorbed by banks.

---

**Exhibit 20: Estimated changes in market risk capital under FRTB**

| Capital charge will be lower under FRTB | 0% | 2% |
| Capital charge will remain the same | 4% | 7% | 11% |
| Market risk capital charge will increase by 1%-30% | 26% | 16% | 17% |
| Market risk capital charge will increase by 31%-60% | 26% | 17% | 16% |
| Market risk capital charge will increase by 61%-90% | 26% | 26% | 26% |
| Market risk capital charge will increase by 91%-120% | 21% | 13% | 17% |
| Market risk capital charge will increase by greater than 120% | 4% | 5% | 5% |
| Don’t know | 14% | 22% |
"The standardization of credit risk is scary and will create the next crisis," said one bank executive. Yet another said “It is undoing all the good from Basel III.”

– Risk executive

Exhibit 21: Effects of regulatory change on market activities

<table>
<thead>
<tr>
<th>Activity</th>
<th>Post-Basel II/Basel III</th>
<th>Likely effect of FRTB in driving further change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exited some derivative markets</td>
<td>23%</td>
<td>45%</td>
</tr>
<tr>
<td></td>
<td>45%</td>
<td>50%</td>
</tr>
<tr>
<td></td>
<td>78%</td>
<td>64%</td>
</tr>
<tr>
<td>Exited provision of some</td>
<td>23%</td>
<td>45%</td>
</tr>
<tr>
<td>longer-dated swaps</td>
<td>32%</td>
<td>56%</td>
</tr>
<tr>
<td></td>
<td>56%</td>
<td>64%</td>
</tr>
<tr>
<td>Increased hedging</td>
<td>15%</td>
<td>23%</td>
</tr>
<tr>
<td></td>
<td>27%</td>
<td>32%</td>
</tr>
<tr>
<td></td>
<td>46%</td>
<td>44%</td>
</tr>
<tr>
<td>Broadly cut back on market-making</td>
<td>15%</td>
<td>23%</td>
</tr>
<tr>
<td></td>
<td>27%</td>
<td>33%</td>
</tr>
<tr>
<td></td>
<td>44%</td>
<td>54%</td>
</tr>
<tr>
<td>Exited market-making in some</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>liquid markets</td>
<td>23%</td>
<td>15%</td>
</tr>
<tr>
<td></td>
<td>44%</td>
<td>18%</td>
</tr>
<tr>
<td>Exited market-making in illiquid</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>equities</td>
<td>32%</td>
<td>15%</td>
</tr>
<tr>
<td></td>
<td>33%</td>
<td>18%</td>
</tr>
<tr>
<td>Exited market-making in</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>illiquid bond markets</td>
<td>32%</td>
<td>15%</td>
</tr>
<tr>
<td></td>
<td>33%</td>
<td>18%</td>
</tr>
<tr>
<td>Moved from position taking to flow</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>trading</td>
<td>5%</td>
<td>15%</td>
</tr>
<tr>
<td></td>
<td>44%</td>
<td>18%</td>
</tr>
<tr>
<td>Moved market-making to home market</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td></td>
<td>8%</td>
<td>18%</td>
</tr>
</tbody>
</table>
Other regulatory changes have had a significant effect on bank operations. Preparation for regulatory stress tests is taking up an increasing amount of banks’ time. Overall, 86% of banks needed one to three months to complete preparation in 2016, up from 81% in 2015 and 71% in 2014. Nearly twice as many G-SIBs (42%) as non-G-SIBs (22%) took three months in 2016 – longer than in each of the last two years.

The need for more time could be explained by banks’ continued efforts to update or otherwise improve their regulatory stress-testing approach: 80% of G-SIBs and 71% of non-G-SIBs reported that they had created and implemented new methodologies in the past 12 months. Improvements of this kind are now routine, with nearly the same proportion making such changes in the 12 months prior to last year’s survey.

Banks and G-SIBs particularly, acknowledged that the regulatory stress tests have had positive effects: preparation has increased focus on stress testing by boards and senior managements; improved internal testing; and enhanced internal processes (see Exhibit 23). “Stress testing is prompting businesses to review what they are doing and considering whether they should keep on doing it,” said one risk executive. But there are negative sentiments about stress-testing as well, as 65% of G-SIBs and 84% of non-G-SIBs said that the work required for stress tests has taken time and resources away from other important risk initiatives.

**Exhibit 22: Estimate of the aggregate increase in CET 1 required for Basel III, post-Basel III and G-SIB surcharge**

- **Less than 30%**: 26% (Overall), 21% (G-SIB), 24% (Non-G-SIB)
- **31%-50%**: 7% (Overall), 6% (G-SIB), 8% (Non-G-SIB)
- **51%-70%**: 16% (Overall), 11% (G-SIB), 21% (Non-G-SIB)
- **71%-90%**: 3% (Overall), 2% (G-SIB), 5% (Non-G-SIB)
- **91%-100%**: 11% (Overall), 10% (G-SIB), 12% (Non-G-SIB)
- **101%-130%**: 8% (Overall), 7% (G-SIB), 9% (Non-G-SIB)
- **Above 130%**: 21% (Overall), 20% (G-SIB), 22% (Non-G-SIB)
- **Do not know**: 16% (Overall), 15% (G-SIB), 17% (Non-G-SIB)
Easing the pressure will take more time

Banks find themselves caught between rising capital and liquidity requirements and pressure from shareholders to increase ROE. Few, if any, see an end to these pressures in the short to medium term.

So where does this leave the banks? They must comply with regulations and cannot afford to ignore the wishes of their shareholders. Some interviewees thought that the effect was making the banking sector an unpopular investment.

Banks have to closely manage costs going forward while managing risks in such a way that prevents a repeat of the massive conduct event costs of recent years. This means investing in new and better ways of assessing and managing non-financial risks and enhancing first-line accountability.

Strategically, banks may have to accept that, for the foreseeable future, they will have to make ongoing revisions to the business portfolio and suite of products and services. Strategic adoption may be the new game in town. Finding the blueprint for sustainable and dependable bank returns may prove elusive for a while. As one executive put it, “The biggest impact [of the Basel agenda] is continually having to simplify our product offering.” The same could be said of banks’ businesses and geographic footprint. Banks are likely to continue to find it difficult to pass all of the costs of higher capital to customers, which leaves exit from activities the main recourse.

Not surprisingly, firms are once again focusing on capital optimization. Pre-crisis, this often meant optimizing against regulatory and rating-agency expectations to enable banks to decapitalize. Post-crisis, this is not an option; quite the contrary, regulators continue to narrow opportunities to manage capital down in this way. Instead, firms have to optimize capital in a way that will please regulators and investors alike, channeling capital toward those business that provide the most sustainable, least volatile, risk-adjusted returns.

Exhibit 23: The impact of regulatory stress tests on internal stress-testing programs

<table>
<thead>
<tr>
<th>Event</th>
<th>Overall</th>
<th>G-SIB</th>
<th>Non-G-SIB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leading to more focus on stress testing at board, senior management level</td>
<td>72%</td>
<td>63%</td>
<td>90%</td>
</tr>
<tr>
<td>Improving internally driven tests</td>
<td>66%</td>
<td>63%</td>
<td>70%</td>
</tr>
<tr>
<td>Leading to enhanced internal processes</td>
<td>60%</td>
<td>55%</td>
<td>70%</td>
</tr>
<tr>
<td>Reducing time and resources availability for other risk initiatives</td>
<td>40%</td>
<td>39%</td>
<td>40%</td>
</tr>
<tr>
<td>Reducing time and resources available for management-driven stress tests</td>
<td>25%</td>
<td>38%</td>
<td>45%</td>
</tr>
</tbody>
</table>

A set of blueprints for success | 37 |
EY surveyed IIF member firms and other top banks in each region, in conjunction with the IIF, from April to July 2016. Participating banks’ CROs or other senior risk executives were interviewed by EY or completed an online survey, or both. In total, 67 firms across 29 countries participated. The charts in this report display data for banks that completed the quantitative survey, while the text includes information gleaned from both the quantitative survey and qualitative interviews.

Participating banks are listed below by geographic region. An asterisk after the bank name indicates that it is one of the 23 G-SIBs that participated. Of the others, 25 identified their bank as a domestic G-SIB. The firms that completed the online survey represented a range of asset size (as of 31 December 2015) from 7% with US$2 trillion or more to 17% with US$100b or less; the largest percentage (35%) was US$100b–US$499b. Most (88%) of the institutions operated in four or more countries, with 22% operating in more than 50 countries. Most (62%) viewed their institution primarily as a universal bank, with 23% and 10% viewing their institutions as a primary retail and commercial bank or investment bank, respectively.
<table>
<thead>
<tr>
<th>Africa/Middle East</th>
<th>Asia-Pacific</th>
<th>Europe</th>
<th>Latin America</th>
<th>North America</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arab Bank</td>
<td>Australia and New Zealand Banking Group Limited (ANZ)</td>
<td>Barclays*</td>
<td>Banco Bradesco</td>
<td>Bank of Montreal</td>
</tr>
<tr>
<td>Arab Banking Corporation B.S.C.</td>
<td>Bank of China* and Bank of China (Hong Kong) Limited</td>
<td>BNP Paribas*</td>
<td>Banco BTG Pactual S.A.</td>
<td>Canadian Imperial</td>
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<tr>
<td>BLOM Bank</td>
<td>Bank of the Philippine Islands</td>
<td>Commerzbank AG</td>
<td>Banco Nacional de Costa Rica</td>
<td>Bank of Commerce</td>
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<tr>
<td>Emirates NBD</td>
<td>BDO Unibank, Inc.</td>
<td>Crédit Agricole*</td>
<td>Itaú Unibanco</td>
<td>(CIBC)</td>
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<tr>
<td>FirstRand Bank</td>
<td>China International Capital Corporation Limited (CICC)</td>
<td>Credit Suisse Group AG*</td>
<td></td>
<td>Citigroup*</td>
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<tr>
<td>Investcorp</td>
<td>Commonwealth Bank of Australia (CBA)</td>
<td>Danske Bank Group</td>
<td></td>
<td>Fifth Third Bank</td>
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<tr>
<td>National Bank of Kuwait</td>
<td>Industrial and Commercial Bank of China Ltd (ICBC)*</td>
<td>Deutsche Bank AG*</td>
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<td>Goldman Sachs*</td>
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<td>Standard Bank</td>
<td>Macquarie Group Limited</td>
<td>DNB</td>
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<td>Morgan Stanley*</td>
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<td>Maybank</td>
<td>Erste Group Bank AG</td>
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<td>Northern Trust</td>
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<td>Mitsubishi UFJ Financial Group*</td>
<td>Groupe BPCE*</td>
<td></td>
<td>Corporation</td>
</tr>
<tr>
<td></td>
<td>Mizuho Financial Group*</td>
<td>Grupo Santander*</td>
<td></td>
<td>PNC</td>
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<tr>
<td></td>
<td>National Australia Bank Limited (NAB)</td>
<td>HBSC Bank plc*</td>
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<td>Regions Bank</td>
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<tr>
<td></td>
<td>Nomura Holdings, Inc.</td>
<td>Intesa Sanpaolo</td>
<td></td>
<td>Royal Bank of Canada (RBC)</td>
</tr>
<tr>
<td></td>
<td>The Norinchukin Bank</td>
<td>KBC Bank N.V.</td>
<td></td>
<td>Scotiabank</td>
</tr>
<tr>
<td></td>
<td>Sumitomo Mitsui Banking Corporation*</td>
<td>Lloyds Bank</td>
<td></td>
<td>State Street</td>
</tr>
<tr>
<td></td>
<td>United Overseas Bank (UOB)</td>
<td>Nordea Bank AB*</td>
<td></td>
<td>Corporation*</td>
</tr>
<tr>
<td></td>
<td>Westpac Banking Corporation</td>
<td>Piraeus Bank</td>
<td></td>
<td>TD Bank</td>
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<tr>
<td></td>
<td></td>
<td>Royal Bank of Scotland (RBS)*</td>
<td></td>
<td>U.S. Bancorp</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Skandinaviska Enskilda Banken AB (SEB)</td>
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<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Société Générale S.A.*</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Standard Chartered PLC*</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>UniCredit Group*</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Union Bank of Switzerland (UBS)*</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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