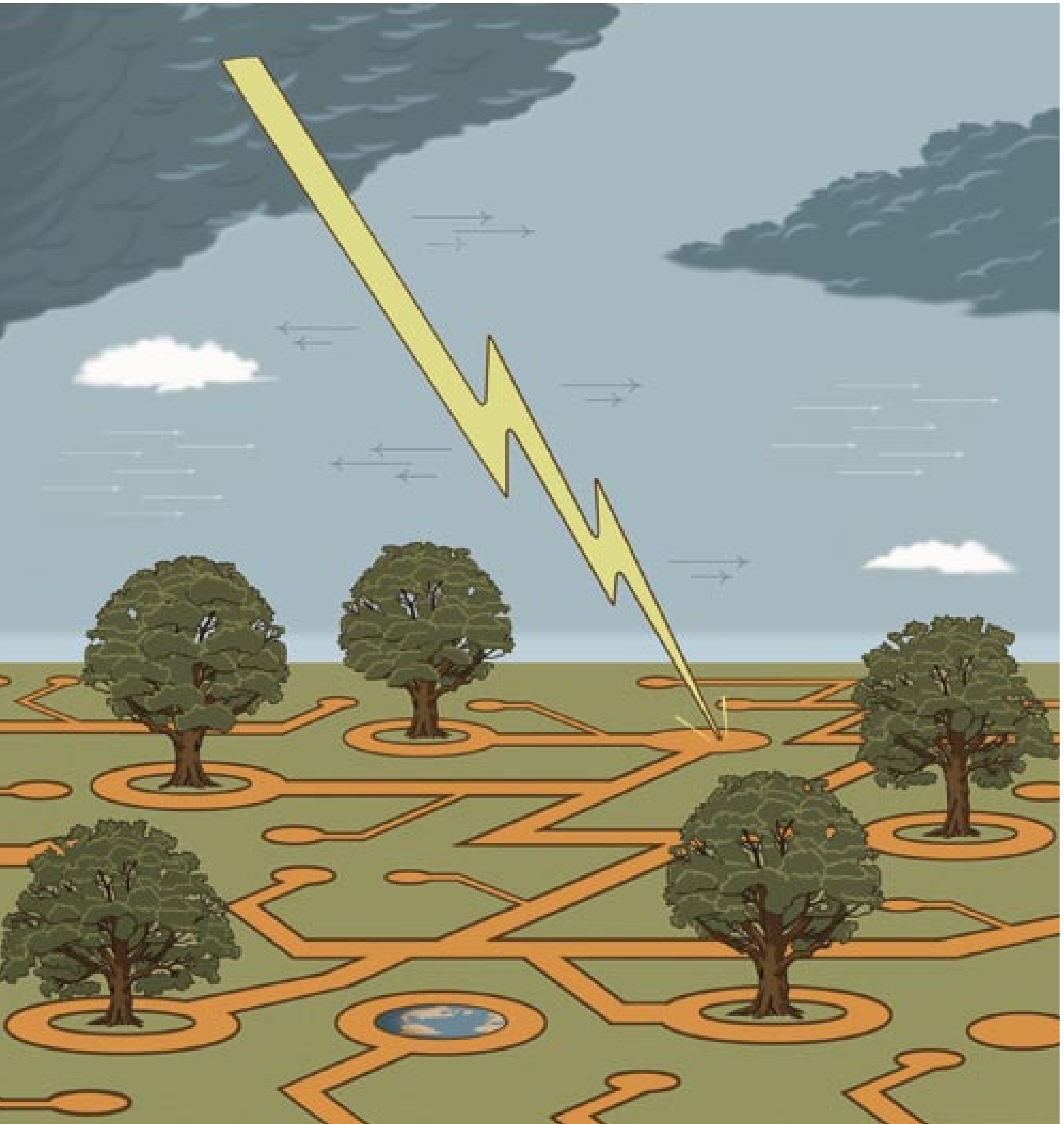
5. The Age of Risk and Regulation



- Taking control of operational risk management
- Actively managing the credit portfolio
- Banks' role in getting regulation right

Recent collapses in the financial sector have brought home the message that risk management can no longer be ignored. Yet defensiveness has its dangers, too. Banks must increasingly strike a balance between protecting themselves against unwise bets and encouraging the sort of entrepreneurialism needed to take advantage of promising new opportunities.

Financial institutions face four broad types of risk. Market risk represents their exposure, for good or ill, to price movements in the markets. Credit risk is the probability attached to whether any given borrower or counterparty will fail to honor a contractual obligation. Operational risk (which carries with it huge reputational risk) is the exposure that results from failings in an institution's operational processes. And business risk covers anything that directly affects a company's revenues, including regulatory risk.

The three articles that follow highlight areas of particular concern or unusual opportunity.

"Taking control of operational risk management" addresses an issue that is top of CEO minds (not least in the wake of news that a trader at a multi-billion-dollar hedge fund lost well over half the value of its assets in a single week in September 2006). "Actively managing the credit portfolio" shows how some banks are opening up new sources of value via a more activist approach to credit management. Finally, "Banks' role in getting regulation right" urges banks to join forces with national and global regulators in a push for more effective and less burdensome regulation.

Banks' role in getting regulation right

Greg Wilson and Philipp Härle

Banks throughout the world are finding they have to manage regulation more and more, and at a variety of levels. Regulators have, for instance, actively encouraged market forces through liberalization (as in China, central Europe, and central Asia), through the opening up of markets previously closed to outsiders (as in Italy, where several domestic banks have recently been acquired by institutions from abroad), and through harmonization (as in the European Union's pursuit of more integrated markets). These trends are intensifying the pressures on domestic banks while opening up opportunities for new entrants.

Regulators are also intervening when they spot market failure. Examples include inadequate governance and perceived conflicts of interest, such as the role of equity research in investment banking and the "softing" of brokerage commissions. Consumer-protection legislation, such as the capping of retail cross-border payments across Europe at a domestic level, is affecting banks' P&Ls. Add in the detailed rules of Basel II and MiFID (Markets in Financial Instruments Directive), and the upshot is increased reputational risk as well as regulatory complexity. In short, the competitive landscape is being reshaped.

It's hardly surprising that today's banking CEOs are preoccupied with regulation – in particular, with how its complexity might be reduced and its effectiveness and efficiency improved. Indeed, the regulation of competition, risk management, and customer service has become an urgent issue for companies, consumers, and governments alike. This is especially true of the already heavily regulated financial services industry, given the trends toward higher regulatory costs and more complex compliance at both national and global levels.

The economic benefits that good regulation, combined with market-oriented reforms, can bring to a country are becoming apparent. A recent US report

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demonstrates that equity-market liberalization, including appropriate regulation, can increase real economic growth by a full percentage point, with the largest gains found in countries with high-quality institutions.[1] More recently, McKinsey studies on China and India revealed that financial sector reforms – with sound regulation as their backbone – could boost GDP by up to USD 62 billion and USD 48 billion respectively a year.[2] The rewards that flow from the reform and more effective regulation of the financial sector can no longer be ignored.

A growing burden

There is undoubtedly a need in today's global marketplace for prudent regulation in line with basic market principles at the three main levels of supervision and oversight: at the corporate level by boards of directors and senior management; at the market level by rating agencies, analysts, a free business press, and others; and finally at the government level by national and global financial regulators. That said, the increasingly negative impact of regulation is seen as a top strategic issue by most CEOs (not least those who attended the 2006 World Economic Forum), and is cited in many industry and economic surveys. The "remorseless rise in regulation" dominated executives' concerns in a recent survey of the risks facing banks in 54 countries.[3] Respondents said that excessive regulation pushes up prices for end users, stifles innovation, and discourages new and smaller competitors in financial services.

Other research confirms that the problem is getting worse. A study of large US regional banks carried out by McKinsey in 1991–92 found that their excess regulatory costs (those above and beyond what senior managers thought were prudent banking practices) amounted to between 8 and 12 percent of their non-interest expense (NIE).[4] Almost 15 years later, a study commissioned by the UK's Financial Services Authority (FSA)[5] found that costs in corporate finance, institutional funds management, and investment and pension advice for a median group were 10 to 15 percent higher because of FSA regulation than they would have been otherwise.[6]

As costs increase, so does regulatory complexity – something that affects all stakeholders, not just the financial institutions that are the first point of contact with regulators. As Peter Wuffli, group CEO of UBS, observed, "Partly as a

1 Geert Bekaert, Campbell R. Harvey, and Christian Lundblat, "Does financial liberalization spur growth?" Cambridge, MA: National Bureau of Economic Research, 2005.
2 *Putting China's Capital to Work: The Value of Financial System Reform,* April 2006 and *Accelerating India's Growth through Financial System Reform,* McKinsey Global Institute, May 2006.
3 *Banana Skins 2005: The CSFI's Annual Survey of the Risks Facing Banks,* Center for the Study of Financial Innovation/PricewaterhouseCoopers, UK: Heron, Dawson, & Sawyer, 2005.
4 Gregory Elliehausen, "The cost of bank regulation: A review of the evidence," *Federal Reserve Bulletin,* April 1998 and *Regulatory Burdens: Recent Studies, Industry Issues, and Agency Initiatives,* Washington, DC: US General Accounting Office, staff paper, GAO/GGD-94-28, December 1993.
5 *The Cost of Regulation Study,* Deloitte & Touche commissioned by the Financial Services Authority, UK: June 2006.
6 "Regulation costs break FSA good practice rules," *Financial Adviser,* July 6, 2006.

result of the rapid globalization and evolution of the financial sector, regulatory requirements have become highly complicated. There is a need to ensure that regulations are developed in a way that they are able to keep pace with the rapid change in the market and accurately reflect the global character of the financial services business."[7]

Recent developments

There is little prospect of the regulatory burden growing lighter any time soon. The new Basel II capital rules that are coming into play globally incorporate some elements of best practice in risk management, but are still costly and complex to implement. In Europe, the European Parliament and the European Securities Committee have agreed on secondary legislation for MiFID, and the FSA is set to issue four consultative papers and one discussion paper for the industry. Without timely industry input to ensure their workability, these will inevitably lead to higher costs and greater complexity.

Meanwhile, for global competitors, the longstanding and contentious issue of the proper balance between the home and host country supervisor is far from resolved. Indeed, it appears to be worsening as national standards diverge in the absence of a universally accepted standard on cross-border supervision.

In the United States, the archaic state-based insurance regulatory regime is costly and inefficient, and flouts basic competitive principles in many states. Take the property and casualty world, where rate (price) and form (application) approvals by regulators can take months if not years to be processed, hindering innovation and speed to market for new products.

Many emerging markets are returning to more stable regulatory environments after the financial crises of the late 1990s. Although this is a good sign in itself, some markets are muddling through with only partial reforms. Signs of back-sliding and inertia are all too common.

The reality is that a costly and complex regulatory environment is growing still more costly and still more complex, especially for competitors that choose to cross national boundaries to serve customers.

A way forward

So what can banking executives do about all this? We believe they can take two sets of action to minimize the downside and maximize the upside for consumers and economies alike, while still adhering to prudent norms for financial regulation and supervision.

7 Institute of International Finance press release, "IIF to review critical issues in global banking regulation," March 30, 2006.

First, groups of like-minded executives can open a dialogue with policy makers and regulators and agree on an agenda of specific initiatives that meet common objectives.[8] Old ways of regulating – often a one-size-fits-all approach that takes no account of a bank's supervisory standing – can be reconsidered in favor of more performance-based regimes. These would include explicit and transparent incentives for companies that are good corporate citizens and perform well across multiple dimensions, and equally clear sanctions against bad behavior and poor performance.[9]

Second, managers of financial institutions can take independent action to ensure that their own regulatory risk profile is prudently managed and fully compliant with the expectations of their overseers at board, market, and regulatory levels, especially as new performance-based regimes are gradually adopted around the world.

Collective policy actions

Collective actions against a broad array of regulatory issues can be taken either by organized trade associations or by ad hoc coalitions galvanized by a single issue or common threat. Such actions are typically reactive, starting with a basic diagnostic of the regulatory landscape and then building a consensus around a set of guiding principles, creating a common vision, and finally developing a strategy for the future regulatory environment. Since policy formulation and regulatory implementation tend to take years, not months, participants will need to be aware that executing their strategic plan is likely to be a long haul.

One useful way for a trade association to develop a successful strategy is through a portfolio of initiatives. By drawing on members' ongoing regulatory priorities, the association should be able to identify new initiatives that are in line with its guiding principles and specific needs. These initiatives are likely to range from the familiar (such as continuing to push on efficient implementation of Basel II), to those that involve slightly more risk and may be a little less familiar (such as proactively engaging regulators in opening markets like China and India), to those that are likely to take a long time to implement but need to be planned as of now (such as designing a set of global corporate governance standards for financial institutions operating across borders).

Some initiatives will have more impact than others. Some may not achieve all their objectives, especially in difficult regulatory environments like those of China, Argentina, Venezuela, and Russia, to name a few. Some may fail outright thanks to the vagaries of the political and policy process. Associations and coalitions shouldn't neglect potential quick wins – those few initiatives

8 See, for example, *Market-Incentive Regulation and Supervision: A Paradigm for the Future,* Washington, DC: The Bankers Roundtable, April 1998.

9 See also *Building Better Banks: The Case for Performance-based Regulation,* Chicago: Bank Administration Institute and McKinsey & Company, 1996.

where a decisive near-term intervention could produce tangible results in a relatively short space of time.

Fortunately, successful trade associations exist at both national and global levels. In the United States, the Financial Services Roundtable, a group of top managers from leading providers, represents members' views to all branches of government and federal financial regulators, and aims to provide powerful legislative and regulatory advocacy. In Germany, the Initiative Finanzstandort Deutschland (IFD) – which draws its members from leading banks and insurers, the Deutsche Börse, the Bundesbank, banking associations, and the ministry of finance – works to improve Germany's standing both as a market and as a location for financial services firms.

At the international level, the Institute of International Finance (IIF) brings together institutions from more than 60 countries to focus on global and regional economic and regulatory issues. It seeks to engage policy makers and regulators in a continuing dialogue with the industry on key issues of mutual concern. These range from fostering mutual trust and respect for corporate and supervisory judgment, to emphasizing principles-based solutions wherever possible, to promoting global coordination in the development of new standards and supervisory processes.

Although it is too early to tell how successful these efforts will be, they offer helpful pointers as to the kind of collective action that senior management can take to encourage policies and regulation that maximize customer service and economic growth.

Individual company initiatives

Just as banks need to engage in collective action to secure a favorable regulatory climate, so their senior management and boards of directors must take steps to support overall corporate strategy with a fully aligned regulatory strategy. Often a regulatory review will be triggered when a bank enters new markets, develops new strategies for existing markets, or offers new products and services. Sometimes a new policy or regulation (such as the introduction of the Sarbanes-Oxley law on corporate governance in the United States, or the European Commission's tougher stance on member states' protective behavior toward cross-border mergers) will force a comprehensive review.

One South American company decided to focus its strategy on the United States, and revamped its corporate governance and regulatory risk management accordingly. It seized the initiative by presenting its new approach to a group of US regulators for their review and discussion. The bank didn't need to obtain any formal regulatory approvals, but its openness earned it additional good will from the supervisors.

Similarly, a large Asian financial services company with a wholly owned subsidiary and multiple branches in the United States needed to upgrade its risk management and corporate governance both at home and abroad in advance of a listing on the New York Stock Exchange. After carrying out an internal diagnostic at headquarters and at all its US operations, as well as a benchmarking exercise with seven or eight global peers, it put in place a clear regulatory and governance plan.

In a third case, a non-banking company developed a business case and regulatory application to license a state-chartered industrial bank in Utah that was not a member of the Federal Reserve System. In recent years, companies as diverse as retailers, securities firms, and car makers have acquired these FDIC-insured banks and transformed themselves, in part, into new financial holding companies in pursuit of their competitive strategy to serve their customers better.

Our experience shows that companies can do much to ensure that the management of regulatory risk actually contributes to the creation of shareholder value instead of destroying it.[10] CEOs and their boards can act not only to manage the onslaught of new regulation, higher compliance costs, and tougher enforcement, but also to capture the rewards of prudent and efficient regulatory risk management. Considerable strategic benefits can flow to a company that maintains high standards, especially as new performance-based regulatory regimes come on line around the world. There are three critical steps in this process.

First, senior management, with the board's oversight, can conduct an independent diagnostic of the organization's risk-management capabilities across the three traditional pillars of regulation: competition and market conduct, risk management, and customer service and protection. This will involve reviewing product offerings and codes of business conduct, regulatory capital and governance requirements, and consumer disclosure, guarantees, and dispute resolution.

With this objective review in hand, the bank can then realign its regulatory risk management to support its competitive strategy. This process will typically be driven by the bank's general counsel or chief risk officer (CRO), with support from staff in external and/or regulatory affairs. Often the diagnostic will uncover gaps that need to be urgently addressed. In any case, a monitoring and management process needs to be institutionalized across the organization.

10 See Gregory Wilson, *The Value of World-class Financial Regulatory Risk Management,* McKinsey & Company, October 2004.

Finally, a consolidated overview of all aspects of regulatory risk management needs to be in place at the CEO and board level. Banks may need to change their organization structure so that the CRO reports directly to the CEO, and to compile regular reports to give their boards a comprehensive picture of how their strategy relates to the regulatory environment.

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No matter where in the world a bank operates, the regulation of competition, risk, and customer service will be a critical issue for its senior management. In our view, regulatory costs and complexity can only get worse unless the industry joins forces with national and global policy makers and regulators to push for more effective and efficient regulation. Acting alone or with groups of like-minded peers, banks can take steps both to minimize the downside of regulation and to tap into the potential rewards.