Recent trends in regulation and supervision of financial institutions

(Introductory talk delivered by G Gopalakrishna, Director, CAFRAL at the CALP 2015, Lonavla on 2nd February 2015)

The financial crisis has shown that there is no financial services model which could be described as "fail-proof". We saw universal bank, investment banks (e.g. Lehman Brothers, Bear Stearns) and retail banks which either failed or were merged with another entity or required governmental support. The financial crisis revealed severe shortcomings in the management of risks by financial entities. It was observed that banks had low levels of loss absorbing capital and high leverage. The banks placed excessive reliance on wholesale funding and had low levels of stable funding. Risk appetite was not clearly articulated and implemented. Capital planning was not comprehensive and forward-looking. As a result, banks did not fully appreciate the risks inherent in their business strategies and misjudged their long term capital needs. Instead of conserving capital, they continued to pay dividends and repurchase common shares. Later when losses surfaced during the financial crisis, banks did not have adequate levels of loss-absorbing capital. All these issues have underlined the need for having a strong risk culture, ethical standards for conduct and risk governance framework by financial institutions.We have seen during the financial crisis in 2008 that the developed world banks from Australia, Canada, Singapore and New Zealand were not impacted during financial crisis. The reason was "they were doing only that business whose risk they understood". Secret of success in banking is to understand risk and compliance requirements of business and building a risk culture within the bank.

2. As financial institutions have differing business models and complexities, it is important that each financial institution understands its mission and lays down a risk appetite framework (RAF). More importantly, it is necessary that the risk appetite is communicated throughout the organisation and translated into appropriate business strategies and form an integral part of business decision making. Establishing an effective RAF helps to reinforce a strong risk culture at financial institutions, which in turn is critical to sound risk management. A sound risk culture will provide an environment that is conducive to ensuring that emerging risks that will have material impact on aninstitution, and any risk-taking activities beyond the institution's risk appetite, are recognised, escalated, and addressed in a timely manner. The Financial Stability Board (FSB) in its April 2014 paper, 'Guidance on Supervisory Interaction with Financial Institutions on Risk Culture', lists embedding the risk appetite into the businesses as one of the foundational elements for a sound risk culture.

3. The recent crisis has emphasized the importance of effective capital planning and longer-term capital maintenance. A bank's ability to withstand uncertain market conditions is bolstered by maintaining a strong capital position that accounts for potential changes in the bank's strategy and volatility in market conditions over time. Banks should focus on effective and efficient capital planning, as well as long-term capital maintenance. An effective capital planning process requires a bank to assess both the risks to which it is exposed and the risk management processes in place to manage and mitigate those risks; evaluate its capital adequacy relative to its risks; and consider the potential impact on earnings and capital from economic downturns. A bank's capital planning process should also incorporate rigorous, forward looking stress testing.

4. While financial institutions have faced difficulties over the years for a multitude of reasons, the major causes of serious banking problems continue to be lax credit standards for borrowers and counterparties, poor portfolio risk management, and a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties. This experience is common in both advanced and developing countries.

5. The Board of Directors and senior management should therefore possess sufficient knowledge of all major business lines to ensure that appropriate policies, controls and risk monitoring systems are effective. They should have the necessary expertise to understand the infra lending, capital markets activities, Securitisation and derivatives activities and the associated risks. The board and senior management should remain informed on an on-going basis about the risk management practices and the bank's activities evolve. In addition, the board and senior management should ensure that accountability and lines of authority are clearly delineated. With respect to new or complex products and activities, senior management should understand the underlying assumptions regarding business models, valuation and risk management practices. In addition, senior management should evaluate the potential risk exposure if those assumptions fail. Before embarking on new activities or introducing products new to the institution, the board and senior management should identify and review the changes in firm-wide risks arising from these potential new products or activities and ensure that the infrastructure and internal controls necessary to manage the related risks are in place.

6. Risk management must be embedded in the culture of a bank. It should be a critical focus of the CEO/Managing Director, Chief Risk Officer (CRO), senior management, trading desk and other business line heads and employees in making strategic and day-to-day decisions. For a broad and deep risk management culture to develop and be maintained over time, compensation policies must

not be unduly linked to short-term accounting profit generation. Compensation policies should be linked to longer-term capital preservation and the financial strength of the firm, and should consider risk-adjusted performance measures. In addition, a bank should provide adequate disclosure regarding its compensation policies to stakeholders. Each bank's board of directors and senior management have the responsibility to mitigate the risks arising from remuneration policies in order to ensure effective firm-wide risk management.

7. As we are aware, the authorities have since initiated many key regulatory reforms to address the above issues. The Basel Committee on Banking Supervision has finalised a new framework which has both micro prudential and macro prudential elements: the micro prudential element focuses on the resilience of the individual institutions by mandating higher and better forms of capital and liquidity and limiting the leverage of firms. The macro prudential approach, on the other hand, focuses on the financial system as a whole and ensures that the entire financial system remains resilient. It is important to note that merely focusing on the micro prudential aspects, i.e., the safety and soundness of individual institutions, is not sufficient to ensure the safety and soundness of the financial system as a whole. It is often said that “the whole is greater than the sum of the parts”, which in the context of the financial system would imply that the stability of the financial system (whole) is not the same as the stability of the parts (the individual institutions). To my mind, one of the key elements of the post crisis reform has been the focus on macroprudential approach. Jurisdictions need to implement sound macroprudential policies in order to ensure that the financial system remains resilient.

8. The regulatory reforms have also aimed at minimising the probability and impact of failure of the “Systemically important financial institutions” (or SIFIs).The SIFIs or SIBs (Systemically Important Banks) will be required to have higher loss absorbency capacity. In addition, the SIBs will be subject to more intense and effective supervision. The SIBs will be required to put in place recovery plans and the Resolution Authority in each jurisdiction will implement the “resolution plans”. The Recovery and Resolution Plans (RRPs) are expected to minimise the impact of external stresses on the firm and if needed, reducing the ultimate cost to the financial system or the real economy in resolving the firm. India does not have not have SIFIs however there is similar requirement for D-SIBs for which RBI has issued similar guidelines.

9. I would like to highlight another aspect today. In the global context, the manner in which capital adequacy is being looked at today by the supervisory authorities is different from what we have been used to so far. These are several metrics of capital adequacy today. Let me elaborate:

- The first measure of capital adequacy is the risk-weighted capital framework. This is based on the risk-weights derived from a historical assessment of risk in each asset class.
- The second measure of capital adequacy is based on stress testing which tries to assess capital in relation to the future risk scenarios.
- The third measure of capital adequacy is based on the leverage ratio which is calculated in proportion to exposures regardless of their risk so as to guard against understatement of risk.

10. Key Drivers and challenges for the banking system:

(i) The regulatory environment in which banks in India are functioning is undergoing a paradigm shift. Apart from the basic approaches for handling major risk categories, Basel II further entails progressive advancement to sophisticated but complex risk measurement and management approaches to credit, market and operational risks depending on the size, sophistication and complexity of the respective banks. Some of the banks have applied to Reserve Bank of India for moving to Advanced Approaches of calculating Pillar I capital.

(ii) In addition, Pillar 2 and Pillar 3 of Basel II emphasize the need for developing better risk management techniques in monitoring and managing risks not adequately covered or quantifiable under Pillar 1 and increased disclosure requirements. The banks are required to carry out Internal Capital Adequacy Assessment Process which comprises a bank's procedures and measures designed to ensure appropriate identification and measurement of all risks to which it is exposed, an appropriate level of internal capital in relation to the bank's risk profile and an application and further enhancement of risk management systems in the bank.

(iii) Basel III Capital Regulations has commenced in India from April 1, 2013 and would be fully implemented as on March 31, 2019. There are various direct and related components of the Basel III framework like increasing quality and quantity of capital, enhancing liquidity risk management framework, leverage ratio, incentives for banks to clear standardised OTC derivatives contracts through qualified central counterparties, regulatory prescription for Domestic Systemically Important Banks and Countercyclical Capital buffer (CCCB) framework.

(iv) The growing emphasis on fair treatment to customers calls for moving over from "Caveat Emptor"(Let the Buyer beware) to the principle "Caveat Venditor"(Let the seller beware) and impending comprehensive framework for consumer protection in India.

(v) Globally heightened regulatory requirements in respect of KYC / AML practices to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities.

(vi) Extensive leverage of technology for internal processes and external delivery of services to customers requiring robust IT governance and Information security governance framework and processes in banks.

(vii) In the background of growing volume of non - performing assets and restructured assets causing concern for the financial as well as the real sector in India, a framework for revitalizing distressed assets in the economy has been implemented with effect from April 1, 2014. The Framework lays down guidelines for early recognition of financial distress, information sharing among lenders and co-ordinated steps for prompt resolution and fair recovery for lenders.

(viii) Frauds are a cause for concern within the banking system which account for a large proportion of total frauds reported in the banking system. Frauds do not just represent lost money; they also indicate serious gaps in banks' systems and processes and in the internal control framework. Plugging these gaps and institutionalizing a mechanism for identifying accountability and taking stringent action against the perpetrators of the frauds is very important for tackling this menace.

(ix) Need for robust Management Information System (MIS) and information technology platforms to provide the board and the top management with timely, reliable and complete risk related information on the bank for effective decision making.

(x) Impending developments in regulatory policies and economic environment are likely to result in banks facing a far more competitive environment in the coming years. As banks' customers – both businesses and individuals - become global, banks will also need to keep pace with the customer demands and develop global ambitions. The challenge for banks will be to develop new products and delivery channels that meet the evolving needs and expectations of its customers.

All these developments will present significant challenges for the banking system and banks will need to prepare themselves to these challenges adequately in terms of human capital, technology and processes.

10. In the aftermath of financial crisis, the Senior Supervisors Group had indicated following key pre-requisites for implementing comprehensive risk data infrastructure:

The Importance of IT Governance in Strategic Planning and Decision Making

(i) Strategic planning processes need to include an assessment of risk data requirements and system gaps.

(ii) Firms with leading, highly developed IT infrastructures bring together senior IT governance functions, business line units, and IT personnel to formulate strategy.

(iii) Firms successful in aligning IT strategies with the needs of business line managers and risk management functions have strong project management offices (PMOs) to ensure that timelines and deliverables are met.

(iv) Firms with effective IT project implementation appoint a data administrator and a data owner with responsibility and accountability for data accuracy, integrity, and availability.
(v) Firms with high-performing IT infrastructures ensure that the Board committees institute internal audit programs, as appropriate, to provide for periodic reviews of data maintenance processes and functions.

Automating Risk Data Aggregation Capabilities
(i) Supervisors observed that while many firms have devoted significant resources to infrastructure, very few can quickly aggregate risk data without a substantial amount of manual intervention.
(ii) Firms with leading practices have very limited reliance on manual intervention and manual data manipulation.
(iii) Supervisors have observed that an inability to aggregate risk data in an accurate, timely, or comprehensive manner can undermine the overall value of internal risk reporting.
(iv) Consolidated platforms and data warehouses that employ common taxonomies permit rapid and relatively seamless data transfer, greatly facilitating a firm-wide view of risk.
(v) Leading firms implement data aggregation processes covering all relevant transactional and accounting systems and data repositories to maintain comprehensive coverage of MIS reporting.
(vi) Leading firms' MIS practices also include periodic reconciliation between risk and financial data.

Thus, there is a need for focus on automation. It is reported that advances in artificial intelligence (AI) mean that machines will be able to perform many of the cognitive tasks now done by humans. Much of the credit assessment and fraud detection work once performed by humans can now done by computers using various pattern recognition techniques. Other data-based work now usually performed by humans can progressively be replaced by intelligent machines, leaving staff to do the ever-decreasing range of things that only humans can do. As Oliver Wyman has reported, the more that financial firms do with machines, the more standardised and manageable their processes will become and the lower their operating costs will be. Technological advance will be the main driver of progress in financial services over the coming years. Yet few senior executives or board members are tech-savvy. Technology has been regarded as a mere execution issue, a matter for the techies in the back office. In fact, it is a matter of the greatest strategic significance. Senior executives must take an active interest in technology and the transformational possibilities it creates for their businesses. In other industries, such as IT implementation and air travel, where firms have dispersed workforces and face major operational risks, relentless process engineering and standardization has improved service quality and reduced costs and risks.

11. I would like to conclude by saying that the banks will have to manage risk and capital at several levels and also ensure that they maintain profitability. This will demand better risk management systems, better resource (including capital) planning, better risk data collection, risk aggregation and risk reporting. All this can be achieved only if the top management is committed to implementing an

effective risk management framework in their institution. The FSB in its report 'Principles for an Effective Risk Appetite Frame work', has emphasised the importance of integrating the risk appetite statement into a financial institution's internal processes and embedding it into the risk culture. You will appreciate that a clear focus on prudent risk culture, laying down of risk appetite framework, development of appropriate business strategies and ensuring its implementation through proper procedures would go a long way in strengthening a financial institution. Regulators and supervisors would also have to play a significant role in ensuring this so as to build a strong and resilient financial system. India has been at the forefront in implementing international regulatory reforms like Basel capital requirements, liquidity framework and compensation practices. The supervision has also moved in tandem with the regulatory changes and as a result we have seen a significant change in our supervision framework in recent years. Not only has the supervision of banks become a continuous process with both on-site and off-site supervision, it has also become risk based which is a distinct improvement from the earlier CAMELS approach.

Thank you