FRTB: Better Get Your Skates On

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Rebuilding Confidence in the Financial Services

The nature of the financial economy has never been under greater scrutiny. With high profile failures colouring the judgement of the population including politicians and regulators, it is important for the industry to both learn the lessons of the past and change to achieve the level of trust that is necessary for effective functioning.

Much has been written about the failures of the few that have tainted the views of the many. It is important for the market to be assured that these cases were essentially isolated and that the ethical standards of most of the financial services industry have not been compromised. This is true in our industry just as much as it is the case in all other industries from manufacturing to accountancy.

As we cannot change the past, we can change the future. The more that commentators focus on raising the profile of past mistakes, the more that they have the impact of reducing trust in our industry. What is needed are solutions to the problems that are faced which can be implemented efficiently and effectively. That is not going to be easy. This article considers what can be achieved and the impact that this is likely to have.

The Changing Model

The model of financial services is changing rapidly. Some of this is driven by changing regulation and other parts are driven by customer demand. New competitors are entering the financial landscape and some of these are coming with brands that are well known and trusted. The costs of both competing and meeting the regulatory requirements are difficult to balance. Shareholder value will dictate that some of the current market participants will find it increasingly unprofitable to remain in some of the markets where they are currently active.

Historically the branch network and infrastructure of the banks was seen as a barrier to new entrants. These barriers no longer exist in an increasingly automated world where the historic costs of a branch network could be seen as prohibitive. New entrants will come with cash and reserves, resulting in their being interested in income generative activities only. One consequence of this is likely to be the end of so-called free banking and a lack of demand for deposits. Another will be
increased speed of processing as historic waiting and checking periods are essentially eliminated.

Financial institutions will need to carefully assess their business models to rise to these challenges. This will include reviewing how they are financed and ensuring that the structure of their firm does not have the impact of rendering them uncompetitive. Systems and controls, not least to identify financial crime and fraud, will need to be built into real-time algorithms that are reliable and tested. However, the conundrum of dealing with multiple levels of controls while enabling ease of use will be a recurring theme.

The Changing Regulation

Much of the regulation that has been implemented in the last few years has been a response to the problems that have been identified. The revised senior managers regime, the new product rules and the revised money laundering directive are all part of this. What the industry and the regulators need to do is communicate to the general market what has been done to change the industry to meet forward thinking demands. The limited understanding of these changes even within the industry and with financial commentators is a constant source of concern.

We need to ensure that these changes are really implemented, and the regulator clearly has a major role to play in this regard. It is right that failures should be acted upon and action taken, but the number of responses that are being implemented at the same time also increase the risk that change itself becomes a major concern. This needs to be managed with the greatest of care. These changes need to be effectively communicated. Problems do not exist throughout the industry although there is the public perception that they do. You deal with perceptions through effective communication, not necessarily by damaging the ability of the industry to achieve the goals society sets for it.

The level of capital and liquidity that the financial institutions are required to now hold does not serve as a measure of an increase of trust in those firms. Most people do not understand terms such as risk weighted assets or capital adequacy. They likely do not fathom the role of stress tests and recovery and resolution plans and probably do not read them. Consequently, increasing trust cannot focus on such matters, rather it is needs to focus on behaviours and actions. Indeed, to increase the efficiency of the market bringing back an element of the losses of the few being picked up by the many is likely to be required.

Remuneration Policies

Much concern has been expressed globally about the role of shareholders in holding Boards to account. It needs to be recognised that not all banks and asset managers are publicly listed companies, and many have dominant shareholders. The regulations published by the Bank for International Settlements already state clearly that remuneration policies should not encourage inappropriate risk taking. We need to see these remuneration codes being adopted globally through the implementation of suitable regulatory standards, rather than listing rules to be effective throughout the industry. It cannot be justifiable that levels of bonus can only be achieved based upon short term goals.

No one is advocating adding more people to boards of regulated firms to represent single interest groups. That will be detrimental to the achievement of goals and missions which as part of the ICAAP process are already reported to and essentially approved by regulators. Rather the role of the non-executive directors should be both supported and enhanced to ensure that they meet the demands that the rules currently in place set upon them. By appointing an independent risk specialist on every regulatory Board as opposed to a finance professional the risk assessment conducted by the Board aligned to its risk appetite will be subject to the required level of
independent scrutiny. This opinion is that such a decision will provide the necessary additional oversight required.

The financial industry is a long-term business where short term decisions can impact long term success negatively. Accordingly, remuneration policies need to reflect this, and appropriate performance attribution analysis conducted leading to the true worth or value added being identified. Compliance with this code should form part of the annual report and accounts of the firm and be independently opined upon.

**Increased Automation and Artificial Intelligence**

As firms are increasingly concerned that rules are being breached or that bias is creeping into the way that they are working, this has led to an increased use of automation. Who has not had a negative experiences of automated call centres whether they are related to credit card companies, banks or telco businesses? The challenge within the financial services firms is that while such automation ensures that there is no bias and rules are complied with, much of the public loathes he process leading to a further erosion in affection and trust.

As payments are increasingly being made real time and new payment platforms or messaging systems introduced, **the march of the real-time world is relentless.** Part of this is regulatory driven and part customer driven – little has been industry driven. The advantage for the customers will be that costs of payments will reduce. The negative consequence is that controls will need to be preventative and leading replacing detective and lagging processes and procedures.

Providing customers with the level of security that they need with a process of systems and controls commensurate with their expectations is always likely to be difficult and is sure to lead to complaints. Many use a mobile device for payments yet have never checked whether it has already been infiltrated by third parties. Others rarely if ever change passwords. There is only so much any industry can be expected to achieve and indeed the education referred to earlier must be part of the solution to ensure that consumers appreciate the problem.

**Corporate Governance**

To meet these challenges is an opportunity for any firm. Those that can develop a business that is sustainable in the medium term, meeting the needs of their target market efficiently and effectively are more likely to succeed. Indeed, increased long-term shareholder value is likely to be the consequence of these changes, rather than being the driver.

The economic environment and the speed of change render a requirement for higher quality senior management. Management need to critically analyse themselves to identify areas where additional skills are required and then either bring them in or acquire them. Reporting to senior management needs to be reviewed to ensure that it no longer purely focuses on the short-term view but at least the five-year view aligned to the ICAAP. Risk management and compliance functions need to actively ensure that the necessary monitoring is in place to provide senior management with the levels of assurance that they require.

**Financial Reporting**

Currently the financial statement that companies prepare are most suitable for the tax authorities. They do not include many of the assets which a firm has, for example its clients, products, intellectual property and skills. If these are the true values of the firm, then none of them are clearly shown in a consistent basis in current accounting and consequently are not audited
by external firms.

A review is required to reconsider the role of statutory accounts to enable them to meet the varied stakeholder requirements. Societal measures should be included within this analysis as well as a valuation applied to what are currently referred to as intangibles. This would then lead to a series of audited scorecards, with the existing tax accounts being relegated to a lower priority. If these processes are to be adopted, then they need to be standardised and generally accepted. Such transparency will likely lead to improved ethical behaviour, but again in the longer term will also lead to increased shareholder value.

Education

It is perhaps surprising to the general public how few people working in financial services are qualified in a relevant topic. There are professional trade organisations and bodies providing qualifications that are of real value. (Noteworthy is the important work conducted by the Chartered Institute of Securities and Investment in this respect.) Banking and finance professionals, managers and staff do need quality accredited qualifications and to achieve them training solutions readily available with the regulator providing the necessary impetus leading to their take up.

These qualifications need to focus **not only on technical issues of banking** (whether investment banking or commercial/retail banking), asset management, wealth management, treasury and insurance; **but also, on ethics and regulation**. Indeed, a **compulsory** qualification addressing these latter issues should be required for all approved persons.

Education should not just be limited to members of the industry, however. Society should accept some level of responsibility for its role. It is perhaps surprising that our education system is happy to explain the role the Romans played and the industrial revolution yet does not explain why a pension is important or the role of insurance. Higher investment in financial literacy should ideally form a part of the general curriculum for all schools, leading to more intelligent purchasers – surely the greatest of all financial societal economic controls.

This article is intended to be part of the current industry and societal discussions surrounding trust and integrity in the financial and as always, any comments are gratefully accepted.