GLOBAL riskupdate

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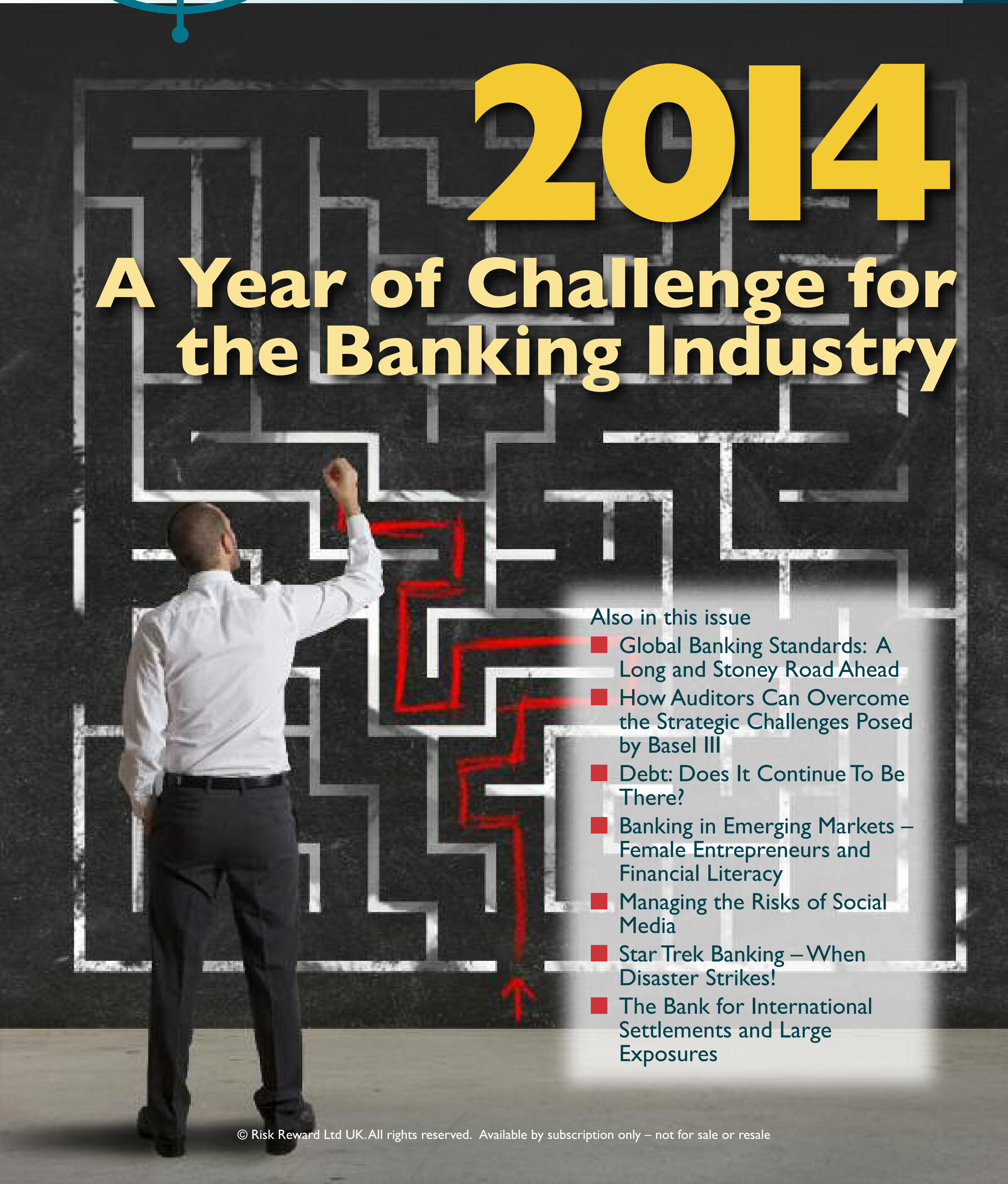

2014

A Year of Challenge for the Banking Industry

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How Auditors Can Overcome the Strategic Challenges Posed by Basel III

Basel III is a gamechanger for auditors as it is the singularly most important factor in linking regulatory requirements to strategy. It is now virtually impossible for auditors to focus on the former without thoroughly understanding the implications of the latter. Jonathan Ledwidge, Director of Risk & Internal Audit at Risk Reward Limited, asks how should auditors be approaching this task?

There was a time when auditors were told that they should focus on risk, internal controls and governance—and perhaps many are still being told that.

Alternatively, while it is accepted that some understanding of the business in question was always critical to the success of any audit, auditors generally spent very little time assessing and challenging the actual strategy. For the most part many auditors were content with confirming that a document outlining the strategy existed.

However, the far reaching implications of the Basel regulations and the stringent requirements of Basel III in particular means that it has now become vitally important that auditors have more than a rudimentary grasp of the business strategy.

The Legislative Force That Is Basel III

Basel III was created as a response to the Financial Crisis of 2008. Reactions to the legislation have varied depending on one's particular perspective – public, government/regulator or banker.

There is no question that banks are held in very low esteem and the reality is that no amount of legislative or regulatory action short of closing many of them down would have been deemed satisfactory in the eyes of the public.

There is no question that the response of governments and regulators has been driven by much of this angst and many within the banking community still believe that what came out of Basel III was overkill. It includes:

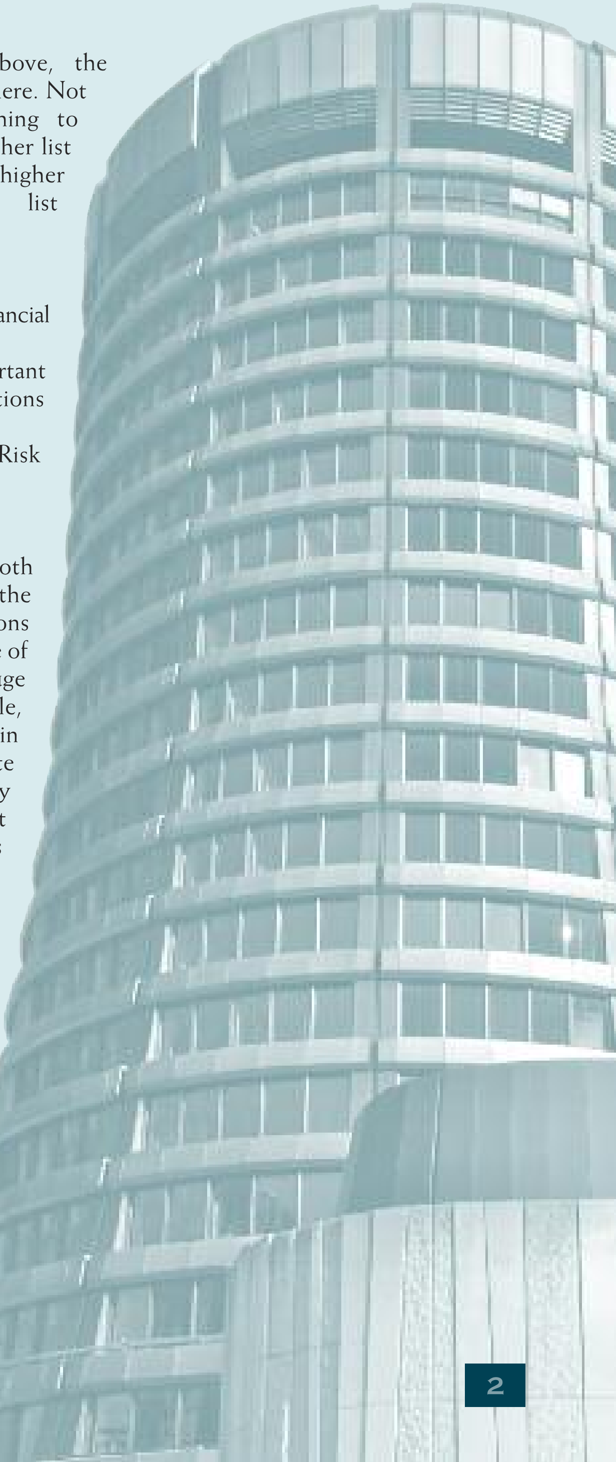
- Increased Minimum Capital Levels
- The addition of a Capital Conservation Buffer
- The further addition of a Countercyclical Capital Buffer
- Greater Restrictions on Instruments Eligible for Consideration of Capital
- A Liquidity Coverage Ratio (LCR)
- A Net Stability Funding Ratio (NSFR)
- A Leverage Ratio

Despite, all of the above, the regulators did not stop there. Not wanting to leave anything to chance they added a further list of items that attracted higher capital charges. The list included:

1. OTC Derivatives
2. Exposures to other Financial Institutions
3. Systemically Important Financial Institutions (SIFIs)
4. Counterparty Credit Risk (CCR)
5. Securitisations

The impact of this on both the organisation and the institutions audit functions has been huge. In the case of the former it has meant huge investments in people, systems and processes in order to both demonstrate and achieve regulatory compliance. The impact on the audit function has been similarly seismic in that it now has to ensure that:

1. The board, management, governance and internal control structures responsible for responding to this regulatory avalanche are up to the task



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2. That risk and compliance functions have the professional competence and resilience to effect the necessary changes
3. The IT, Systems and Processes necessary for effecting the actual change are:
    a. Adequate
    b. Effective
    c. Secure
4. There is a high standard of integrity in the quality, transmission and reporting of data
5. The quantitative models that support the calculation of credit, market and operational risk exposures are subject to appropriate validation and control procedures
6. That the fulfilment of the Basel III implementation is not merely an additional task but that it is seen as integral to as well as fully integrated with the business and decision-making processes at the tactical, strategic and operating levels.

Items 1-3, it can be argued, are consistent with the traditional audit function.

Item 4 is also consistent with the traditional role of audit but is now even more important given the need for regulatory reporting of compliance and adherence to new standards – failure in this arena now has huge regulatory and reputational consequences.

Item 5 presents its own uniquely technical challenges while item 6 brings with it totally new and different challenge – understanding the strategic imperative.

The Strategic Impact of Basel III

In the eyes of many bankers and some independent observers the imposition of Basel III was simply an attempt by the regulators to throw as many rules at the banking industry as they possible could in the hope that this would postpone the onset of another costly disaster.

Never the less, the strategic implications of this change are huge.

In the first instance, giving that capital has become so costly the strategic and competitive analysis of any business now literally begins and ends with what it costs in capital and liquidity terms – not what new market or new business the head of trading wants to pursue.

This alone is a huge change in investment banking in particular from what was previously an opportunistic model i.e. the pursuit of market position in a product in order to match or outdo the competition, to a model where banks will (or should) compete on the basis of the most capital efficient products.

This new reality is evidenced by the fact that many of the banks that were huge players in the highly capital intensive commodities business, the so-called "Wall Street Refiners" such as Barclays, JP Morgan and Morgan Stanley, have either exited or are in the process of exiting that business.

Yet, this change is not limited to complex trading products as increased capital requirements means increased pressure on loan margins. The logical consequence of this is that rather than being judged by the size of their loan books and bloated balance sheets, the new emphasis on capital efficiency and liquidity will mean that banks will now be judged on credit quality and pricing.

This changing dynamics of banks, products and markets will not only significantly alter the competitive landscape but also bring new operational and tactical challenges.

The Tactical and Operational Challenges of Basel III

Costs, operational efficiency and data management present their own tactical and operational challenges in the post Basel III world.

Reduced margins and cost efficiencies are driving real changes in how some units operate. For example it has further accelerated the trend of replacing traders with computer programmes for some products.

Unfortunately, electronic trading is just one part of the business which has come under increased regulatory scrutiny and this has profound implications for the way in which such services are being provided and received.

From an operational risk perspective, if banks want to take

advantage of the much lower capital requirements of the Advanced Measurement Approach (AMA) then they have to develop and execute a comprehensive methodology for monitoring and controlling operational risks. This pursuit of AMA status is normally a vast undertaking which will considerably impact how business and business processes are conducted and managed.

Basel III also brings with it new and greater demands in respect of data integrity and management. In Basel III terms if there are significant errors in regulatory reporting then there might also be significant errors in strategy. Therefore, the validation, collation and integration of the data that supports both the internal decision-making process and the external reporting requirements are all highly critical tasks—one made all the more daunting by the industry's history of legacy systems, rapid expansion and poorly integrated business units.

As such, banks can no longer afford to have inefficient, poorly integrated or poorly managed entities and business units which are subject to frequent operational losses. Operationally efficiency is no longer just an internal management goal it is now a regulatory imperative.

The Role of Audit

It will be almost impossible for auditors to perform their duties without giving due consideration to how each of the above elements impacts the scope of their work and whether or not the business is being conducted not only in accordance with management's objectives but that it is also consistent with regulatory best practice.

From a general perspective the idea that an auditor should focus not just on the actual regulation but on regulatory best practice is not really new. In the normal course of their work auditors are required to do just that, especially when they incorporate letters and other communications from regulators in forming their judgement. Yet, the concept is now even more important for two reasons. They are:

- Basel III and its US equivalent Dodd Frank have more than any other pieces of regulation inextricably linked the fate of individual banks and the entire industry to strict regulatory adherence
- Regulators are also now responsible for reviewing the work of the internal audit function

Consequently, the only way that auditors can properly effect their responsibilities is by developing a full and complete understanding of the strategy, its implications, risks and possible pitfalls in both business and regulatory terms, while understanding the linkages between them.

Fortunately for auditors there is one process which readily facilitates such an approach and it is the audit of the Internal Capital Adequacy Assessment Process (ICAAP).

Auditing the ICAAP

The most important thing that can be said about the ICAAP is that, despite the requirement for annual reporting, it is a process. As such, in order to be effective in auditing the ICAAP auditors must be as concerned with the process as with its outcome.

The reason for this is that the ICAAP, at least in theory, brings together all the elements of business, risk, finance, credit and compliance in order to determine how the institution can meet or better still reconcile its objectives with the demands of the regulator.

The ICAAP directly links the usage of capital and liquidity with the operational, tactical and strategic objectives and/or limitations of the institution and thus requires a comprehensive understanding of all these interrelated elements.

The ICCAP is the process for testing and evaluating all the assumptions on which management seeks to place reliance on in executing its mandate. As such, in order to be successful, the ICAAP must have the full support and approval at the highest levels of the institution.

By embracing the audit of the ICAAP and ensuring that the governance, inputs and dynamics of the process are consistent with their institution's size and complexity, auditors can significantly improve their understanding of the business and with it their ability to audit it.

The author invites your comments via email to JL@riskrewardlimited.com

For further information please contact:

Dennis Cox – CEO
telephone: +44 (0)20 7638 5558
email: DWC@riskrewardlimited.com

Lisette Mermod – New York
telephone: 1-917-310-1334
email: LM@riskrewardlimited.com

Joanna Kraska – Public Relations
telephone: +44 (0)20 7638 5558
email: JK@riskrewardlimited.com