Seminar on Building the Bank’s Strategy around Risk Management

Risk Management as a Core Competence of Financial Institutions

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Manila

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ICRA Management Consulting Services Limited
Agenda

1. Where is Banking headed?
2. The link between Risk management and Strategy
3. Risk management for competitive advantage
4. Discussions
The world is in the throes of an economic recession

- USA, UK, EU and Japan – Moderate to negative growth; 65% of global GDP
- China has grown at 10%+ for two decades; now starting to slow down
- India has grown at 8%+ for several years; has also slowed down
- Russia, Brazil, South Africa and several other G20 countries also slowed down
- A handful of countries in the developing world still growing at 8%
**Banking industry has seen the negative side of risks in the developed world...implications are global**

- The Banking industry after two decades of growth got a jolt in 2008
- Major banks in the US/Europe are supported by Government funds
- Countries are in trouble due to banking crises – Iceland, Spain, Ireland
- The Euro crisis and its resolution is linked to its Banking industry
- Basel II was found inadequate and Basel III has been announced
- The Dodd-Frank Act spells fundamental changes for Banking industry
- A series of scandals in leading banks have dented the industry’s image
What is common to the following disasters?

<table>
<thead>
<tr>
<th>Bank</th>
<th>Year</th>
<th>Loss</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kidder Peabody</td>
<td>1986</td>
<td>$350 mn</td>
<td>Error in profit computation</td>
</tr>
<tr>
<td>Allied Irish Bank</td>
<td>1994</td>
<td>$700 mn</td>
<td>Unauthorised forex trades</td>
</tr>
<tr>
<td>Barings</td>
<td>1995</td>
<td>$1 bn</td>
<td>Wrong bets on Nikkei 225</td>
</tr>
<tr>
<td>Orange County</td>
<td>1994</td>
<td>$2 bn</td>
<td>Profits followed by losses</td>
</tr>
<tr>
<td>Banker’s Trust/P&amp;G</td>
<td>1995</td>
<td>$90 mn</td>
<td>Hedging w/o understanding</td>
</tr>
<tr>
<td>LTCM</td>
<td>1998</td>
<td>$4 bn</td>
<td>Wrong assumptions in trade</td>
</tr>
<tr>
<td>Lehman &amp; Wall Street</td>
<td>2008</td>
<td>???</td>
<td>CDO crisis and the Contagion</td>
</tr>
<tr>
<td>Society Generale</td>
<td>2008</td>
<td>$7 bn</td>
<td>Losses in arbitrage trade</td>
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<tr>
<td>UBS</td>
<td>2011</td>
<td>$3 bn</td>
<td>Unauthorised speculation</td>
</tr>
<tr>
<td>JP Morgan</td>
<td>2012</td>
<td>$5 bn</td>
<td>Model error?</td>
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Banking industry’s scarce resources …

- Capital
- Talent
- Trust

Risk Governance
Agenda

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Financially sustainable banking is a balancing act among Growth, Risk, Profits and Capital

The balancing act

How to Maintain growth, manage risks and improve profitability to sustain capital adequacy

Need to grow

Any growth strategy has inherent risks

Need for striking a balance between growth, risks, and profits

Understand the source of profits and risks

Need the following:

- Understand clients
- Understand risks
- Understand pricing
- Allocate capital

Growth

Profits

Capital

Risks

How to Maintain growth, manage risks and improve profitability to sustain capital adequacy

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Need the following:

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How is the US Banking industry changing?

- US Banking industry needs a new business model
- RoE of banks has fallen below 10%, lower than shareholder expectations;
- Profitability of banks likely to fall further due to changes underway in US; Basel III will definitely need banks to get in more capital
- Consumer de-levering is a new social phenomenon
- The Dodd-Frank Act is likely to have wide-ranging impact on US banks
- Four significant components of US Banking that are likely to change:
  - Retail branch banking
  - Payments
  - Mortgages
  - Fixed income OTC trading
- US banks are dealing with regulatory, strategic, and technology risks
Challenges for Banking sector in Philippines…

- Given the target of infrastructure investments of 5% to GDP, need for credit and banking services likely to accelerate
- A low domestic savings rate, need to keep credit rates competitive, changing regulation and rising competition amongst banks could narrow margins and consequently RoA
- Developments in the bond markets likely to intensify competition for funds
- Increased capital requirements with the implementation of Basel III
- Challenges in achieving financial inclusion
- Bank exposure to customer segment such as Infrastructure likely to increase
- Are there risks of higher NPA due to higher credit growth?
- There may be strategic risks to contend with due to M&A and new partnerships
## Agenda

<table>
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Risk management to gain competitive advantage
- Case vignettes

- A bank in the ME creates a successful portfolio of large corporate credits on the basis of a risk model in lieu of the hitherto prevailing name-lending culture

- A start up bank grows to $15bn asset base in ten years on the strength of highly refined risk assessment, monitoring, and portfolio management

- A leading mortgage finance company has a highly fine-tuned risk management strategy with oodles of investment in technology and a highly motivated middle management

- How a leading bank failed in mortgage finance, but has stormed back in ten years to become the largest financier in the segment

- An large bank uses quantitative models to grow its portfolio in trade finance and SME (“segments where financial statements are unreliable”)
A case study of a bank in India that put risk management at the centre of its strategy...

- A new banking license issued to a financial house in 1994; “How to differentiate from 100 other banks? “

- In the initial years, focus was on minimal credit risk; hence, the bank focussed on a strategy of low cost deposit growth
  - Focussed on top 20 centres; Leveraged its parent’s brand;
  - Thrust on transaction services and clearing house functions – to get float funds
  - Invested heavily in technology; Chose customer segments and services that rode on IT significantly
  - Centralised risk management and drove branches towards business development
  - Obsessive focus on credit monitoring
  - Two strategic acquisitions of other commercial banks
  - Business banking book grown aggressively once a cadre of trained officials and an established risk management system was in place

- One of the best performing banks in India
Risk management mirrored customer segments and the processes used to acquire them …

- Asset base grew by over 10X over the ten years
- Cost of customer servicing through internet is 10% that of branch servicing
- Cost of servicing through ATMs is also about 30% cost of branch servicing
- NPL is below 1%
Risk management as a source of competitive advantage - what needs to be done?

1. Understanding the true nature of risks is very key

2. Defining risk appetite and implementing appropriate systems

3. Paying attention to Risk Governance

4. Creating an appropriate Risk culture
1. Understanding the true nature of risks a bank is exposed to.

1. All risks are not the same; clearly quantifying and comprehending the impact and frequency of various risks

2. Banks must differentiate three types of risks:
   - Those that arise suddenly
   - Those that develop gradually
   - Variations in fortune that help the bank, but could also hurt

3. Risks go beyond balance sheet and profit & loss statements

4. Models have some limitations; how to address these risks?

5. Understanding the true correlation between risks
2. **Defining risk appetite …**

1. How much risk(s) should a bank take on? What is the capacity of the bank to absorb risk?

2. How to measure and quantify the risk?
   - Need for risk measuring system – tools and process go hand in hand

3. How much capital should the bank have (over and above regulatory capital)? Is there a logical basis?

4. What loss limit should be fixed for different business units? How should capital be allocated across business units? What tools?

5. How should scenario testing / sensitivity analysis be done?

6. Risk appetite can be defined only if there are good measuring systems.
3. Risk governance…

1. Who does what in the bank for managing risks?
   - The Board
   - Senior management
   - Rank and file

2. What are the big risks and bets that the bank has taken?

3. Allocating capital to various avenues on a logical basis

4. What to do when something goes wrong? The role of ICAAP

5. Who is accountable for risk?

6. Understanding the 4Ms – (a) Micro (b) Macro (c) Model (d) Management
4. Risk culture…

1. All risks that a bank faces cannot be identified or hedged.  
   - What does a bank do when unknown risks hit the bank?

2. Soft aspects of risk management  
   - Are lessons from managing risks shared across the organisation?  
   - How does the bank treat a breach of compliance?

3. What is the relationship between Risk Dept and the Business Depts?  
   - Is RMD a line department or a staff service?  
   - Is the Risk department like a football goalkeeper?  
   - Complex risks are best understood by business / line personnel
In closing...

- Philippines Banking sector faces growth opportunities and challenges

- A reduction in NIM will push banks to try new avenues with concomitant risks:
  - Banks will need to go for more risky loans to maintain spreads
  - Banks will be pushed to changing processes to reduce Expense: Income ratios
  - Seek avenues for more non-interest income

- Avoiding damages from risks in the quest for growth and profits remains a core controlling function for Risk management and an issue of governance

- There are several examples from the region and the rest of the world to learn from, but the solutions for each bank will have to be home grown
Understanding risk

“Without numbers, there are no odds and no probabilities; without odds and probabilities, the only way to deal with risk is to appeal to the Gods and the fates”.

Source: ‘Against the Gods’ by Peter L Bernstein

Without numbers, risk is wholly a matter of gut
Thank You

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About the Presentation

These slides were presented by Mr. V. Sriram at the Seminar on ‘Building Bank’s Strategy around Risk Management’ held on August 14, 2013 at Manila

Mr. V. Sriram has more than 21 years of work experience in Management Consulting, with about 15 years in Group ICRA and six years with Tata Consultancy Services. He brings deep experience gained from working with a wide variety of banks, financial institutions, non-banks, and Central banks in India, Bangladesh, Sri Lanka, UAE, UK and Africa. He has successfully led consulting teams working on complex projects in the areas of restructuring and risk management with large banks in several countries. He has developed risk scoring models for several business segments for banks in Asia and has assisted a number of banks in implementing Basel compliant risk management systems. Mr. Sriram is a Chartered accountant by training, and is a qualified Cost accountant and Company Secretary.
About IMaCS

ICRA Management Consulting Services Limited (IMaCS), the consulting arm of Group ICRA, is a management consulting firm headquartered in India and with an operating footprint in over 40 countries around the globe. It offers consulting services in the areas of Policy advisory, Strategy, Risk management and Transaction Advisory to Governments, Banks & Financial Institutions, Investors and Corporates.

Over its 18 year operating history, IMaCS has completed over 1500 consulting projects with over 700 clients, including over 100 banks and financial institutions. It has deep expertise in the area of Risk management, where it has completed several projects addressing credit risk, market risk, and operational risk. Besides consulting, IMaCS offers end to end implementation assistance to banks in risk management including diagnostic assessment, model building, risk calculators, advanced risk management systems for Basel II, training, and software systems for credit risk and operational risk management.

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