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Improving bank resilience – kill or cure

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Improving Bank resilience – kill or cure?

Agenda

- **how we got here** *John*
- **the responses by:**
 - the authorities* *Simon*
 - banks* *Simon*
- **insurance in op risk** *John*
- **improving governance/living wills** *Simon*
- **risks to the economy** *Simon*
- **Questions** *one and all*

Where did it all go wrong?



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Some causes - internal



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Credit risk

- > assessment
- > rating agencies

Liquidity

- > scenarios
- > trust

Capital

- > RoE
- > leverage
- > size

Governance

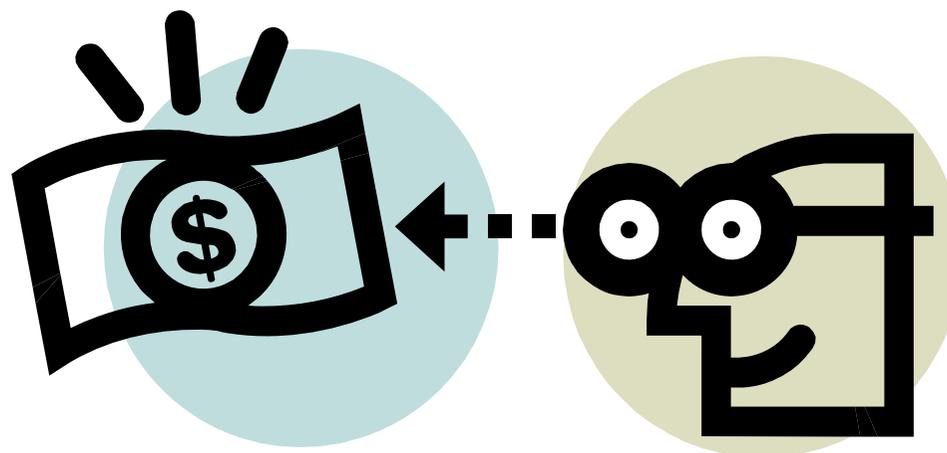
- > challenge
 - Board
 - risk management

‘When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.’, Chuck Prince, Citigroup, 10 July 2007

‘We do God’s work’, Lloyd Blankfein, Goldman Sachs, 8 November 2009

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The Basel II framework

- > Pillar 1 - capital adequacy
- > Pillar 2 – supervisory review
- > Pillar 3 - disclosure

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Pillar 1 - Capital adequacy

Credit Risk

- > Menu of three possible approaches
- > Standardised approach
 - > ***similar to 1988 Accord, but with greater differentiation of classes of asset/exposure***
- > Internal ratings based (“IRB”) approach
 - > ***Use of banks own models/scorecards and historic data***

>Operational risk

- > ***Basic indicator, standardised and AMA***

>Market Risk

- > ***Standard, IMM***

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Pillar 2 - Supervisory Review

- >Banks should have enough capital to support all risks
- >Promote better risk management
- >Dialogue between bank and supervisor

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Pillar 3 – ‘Standardised’ disclosure

- >Scope of application
- >Capital
- >Risk exposures
- >Risk assessment processes

So market can assess capital adequacy and risk management

Insurance for operational risk -Basel II qualifying criteria

- **AMA banks only**
- **Max 20% of operational risk capital can be mitigated through insurance**
- **Coverage/mapping**
- **A-rated claims-paying ability (BBB- in EU)**
- **90 days' notice of cancellation**
- **12 month term to expiry – haircut for less down to 90 days (= zero haircut)**

SIGOR consultation

- **Aim – consistency across jurisdictions**
- **Issues**
 - > supervisory dialogue
 - > transfer of capital
 - > mapping
 - > quantifying insurance mitigation
 - experience requirement for tail events
 - ability & willingness to pay
 - claims settlement time

SIGOR consultation (2) – reliance on AMA approval

“Some brokers and insurers have placed strong emphasis on bank supervisors’ AMA approval processes and ongoing bank supervision, in place of conducting their own review of model adequacy and operational risk management in banks. **Supervisors strongly recommend that insurers and insurance brokers involved in underwriting operational risk perform independent reviews of the AMA of the prospective insureds.**”

“Our members are opposed to sharing information with institutions other than their supervisors.” (BBA response to CP)

SIGOR consultation (3) – traditional and proposed insurance policies

- **‘Basket’ or ‘overlay’ policies:**

- > fill gaps in coverage
- > high deductibles to complement rather than replace existing terms
- > divisibility – breaching conditions of one policy may affect others under the overlay
- > all banks or AMA only?

- **Term**

- > penalty premiums
- > rolling/evergreen 12 months

- **Non-disclosure**

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What the authorities want- the G-20 agenda

- > Transparency and accountability
- > Sound regulation
- > Prudential oversight
- > Risk management
- > Integrity in financial markets
- > International cooperation
- > International Financial Institutions reform

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What has been proposed

- >Increased quantity and quality of capital
 - trade off between benefits of financial stability and costs of capital
- >Reducing pro-cyclicality in the regulatory capital framework
- >Non-distributable 'Economic Cycle Reserve'
- >Leverage ratio
- >Liquid assets buffer
- >Core funding ratio
- >Fundamental review of trading book capital
- >Special regime for systemically important firms
- >Utility banking
- >Living wills
- >Resolution fund

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Making reform happen

- International consensus
 - > *Global standards, pan European regulator?*
 - > *colleges*

- In Europe
 - > *Systemic oversight*
 - > *Beefed up EU authorities*
 - > *Cross-border regulation via colleges*

- UK
 - > *Relative roles of tripartite authorities*
 - > *FSA as thought leader*
 - > *Principles based, outcome focussed*

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What the banks have done

>More capital

	<i>2007</i>	<i>2008</i>	<i>2009</i>
Core Tier 1	<i>130 bn</i>	<i>144 bn</i>	<i>207 bn</i>
PBT	<i>28.4</i>	<i>-25.5</i>	<i>10.3</i>
RoE	<i>16.2%</i>	<i>-8.2%</i>	<i>4.2%</i>

>More liquidity

>Stress testing

>Replaced exited foreign bank lending

>Remuneration!

>Coming soon

- > *Trading book*
- > *Securitisation retention*
- > *More disclosure*

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FSA's (new) approach

- micro vs. macro prudential regulation
- enforcement
- wholesale markets
- sectoral analysis
- conduct of business

- supervisory challenge of:
 - > *senior management and NEDs*
 - > *business models, strategy, sustainability*
 - > *stress testing*
 - > *governance*
 - > *remuneration policies*
 - > *economic substance not legal form*

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improving governance/living wills

- >Role of the NED
- >Independent chief risk officer
- >Role of investors
- >Living Wills
 - Recovery & resolution plans
 - > *Structure/business model neutral*
 - > *Top down*
 - > *idiosyncratic*

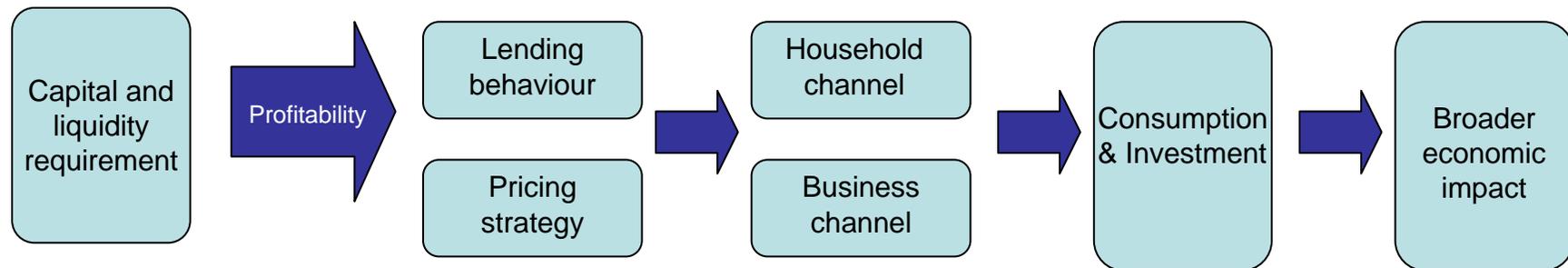
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risks to the economy

- >pricing and lending
- >savings
- >costs
- >risk
- >competition

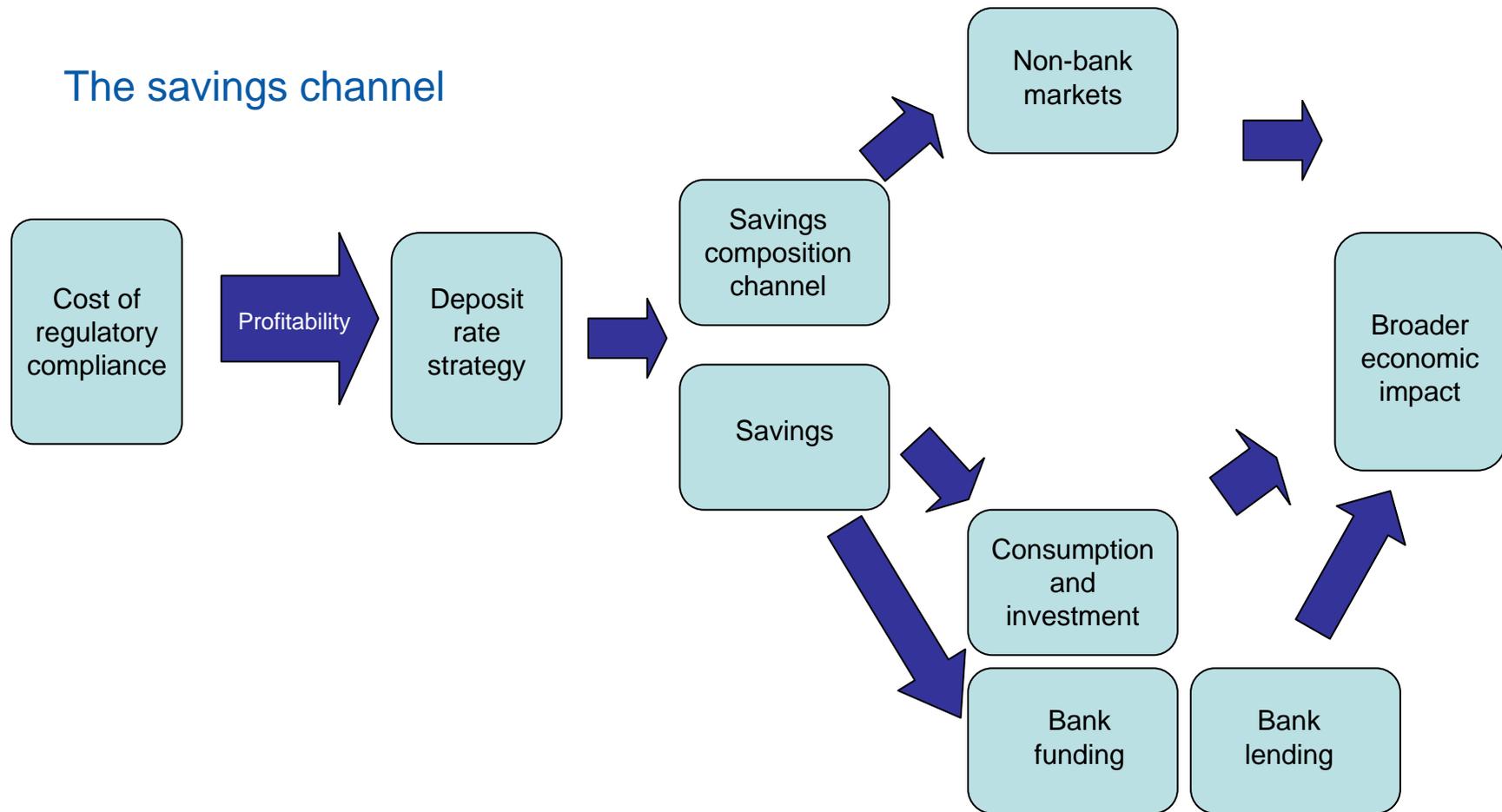
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The pricing and lending channels



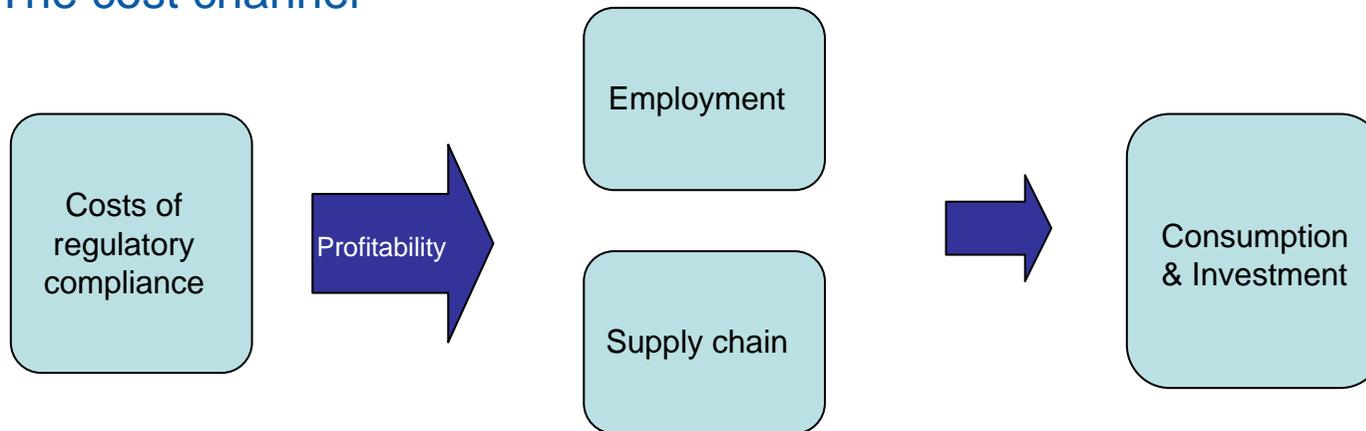
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The savings channel



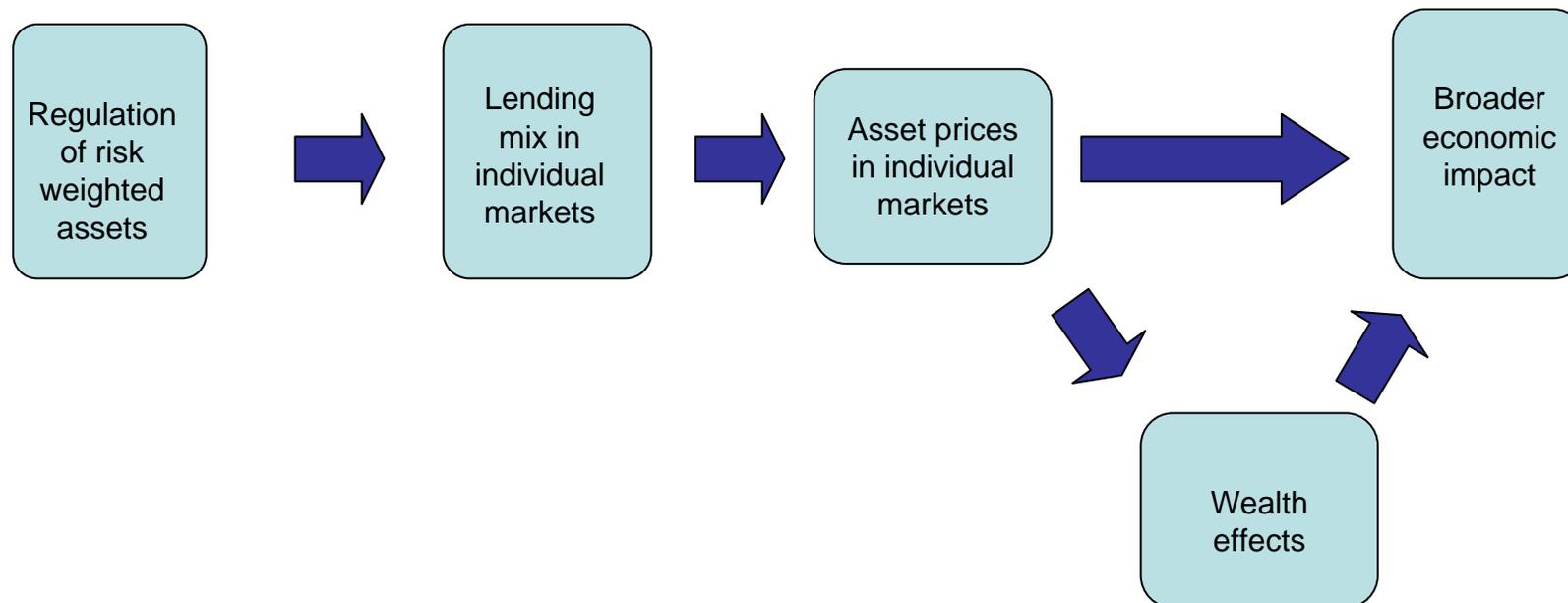
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The cost channel



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The risk channel



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