Key Success Factors for the Commercial Bank Risk Management under Downturn Market

(Chief Risk Officer Opinions)

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Goal of the Presentation

Main Goal:

to present key success factors which were identified by managing risk in the commercial bank in Slovakia during downturn period.

Structure of the Presentation

I. **Global Financial Crisis versus Slovak Economy and Banking Sector**

II. **The Banking Regulation as a Contributor to Key Success Factors**

III. **Key Success Factors of the Commercial Bank Risk Management in Downturn Market**

I. Global Financial Crisis versus Slovak Economy and Banking Sector

- Global financial crisis has started to seriously influence Slovakia at the begining of 2009 **through real economy** crisis and recession in parallel with **Euro adoption in country** (January 1st, 2009).

Impact on the Slovak real economy:

- **small open economy with 5,4 mil. inhabitants;**
- **highly depended on foreign demand (in 2008 (Export + Import)/GDP was168%),**
- **2009 GDP -4,7% (the highest decline among Visegrad countries) vs 2008 GDP 6,2%,**
- **2009 unemployment rate 12,1%; 4.8% growth since the beginning of crisis (also the highest among Visegrad countries) still continues,**
- **budget deficit – 6% (2008 -2,3%),**
- **the highest sectorial hits: cyclical industrial sectors (automotive, steel, chemicals); construction and in services – transport/logistics and tourism.**

I. Global Financial Crisis versus Slovak Economy and Banking Sector cont.

Slovak Banking Sector and Crisis:

Key features of the Slovak Banking Sector

- **highly competitive: 26 banks (15 fully licensed banks and 11 branches of the foreign banks operating on 1 licence);**
- **core business activities are focused mainly on commercial banking and special activities in the area of financing housing construction;**
- **almost 98% banks owned by foreign capital; (mainly Italian, Austrian, Belgium owners);**
- **local banks operate mainly in Slovakia;**
- **highly concentrated (more than 60% of assets owned by 3 largest banks);**
- **sufficiently capitalized and liquid;**
- **banks operate under Basel 2 regulation since January 1st, 2008**

- **Banking sector has been impacted through real economy not liquidity crisis;**

I. Global Financial Crisis versus Slovak Economy and Banking Sector cont.

Slovak Banking Sector and Crisis

A few *specifics* of crisis impact in comparison to the Western European and the U.S. Banks:

- **sector *hasn´t been influenced by liquidity crisis directly* mainly thanks to:**
  - **approaching Euro adoption,**
  - **traditionally over liquidity in the market (which has continued also after January 1st 2009),**
  - **highly conservative securities portfolio with 76% govern. bonds,**
  - **absence of toxic assets.**
  - **but liquidity crisis increased costs of funds**
- ***"timing*" of the global financial crisis was *positive* for Slovakia in *three* ways:**
  - **It „prevented" the Slovak banking sector from deeper problems related to credit losses from aggressive lending.** (2008/2002 housing price index soared up to 270% and household annual loans growth was more than 20%,)
  - **short-term period since the previous Slovak banking crisis(1998-2001**) and the banking sector recovery
  - **sector was well capitalized (with high quality** Tier 1 capital close to 90%and CAD close to 13%) and profitable before crisis

I. Global Financial Crisis versus Slovak Economy and Banking Sector cont.

Slovak Banking Sector and Crisis cont.
A few *specifics* of crisis ...cont.

- ***foreign mother companies risk policies were mostly strict* and the risky transactions, products and investments were mostly concentrated at headquarters not in local banks.**

- ***foreign* owners belong to more conservative groups; their strategies have been focused mainly on traditional commercial bank business model** „originate to hold“ not „originate to distribute“.

- **strict local regulator (National Bank of Slovakia)**
  - was alert and since the beginning of crisis in the U.S. and Western Europe applied stricter regular monitoring of each banking institutions through extended reporting .
  - seriously focused also on monitoring Basel 2, Pillar 2 implementation by the local banks.

I. Global Financial Crisis versus Slovak Economy and Banking Sector cont

Slovak Banking Sector and Crisis.

„Results" of the Crisis Impact on the Slovak Banking Sector

- **lending activities *stagnated* (2009/2008 + 2%), volume of corporate loans *decreased* (2009/2008 -3%), retail segment financing still *grew (*+10%).**
- **non performing loans ratio reached level 5,5% more *than 70% increased* in comparison to 2008.**
- ***investment into the Slovak Republic state bonds and state bonds* of surrounding countries**

  increased.
- **2009 *profit after taxes* in banking sector *decreased* almost by 50% and 11 banks posted loss (in 2008 it was 5 banks).**
- **key *drivers* of decreased profitability *were revenues* (mainly decreased foreign exchange revenues due to Euro adoption and interest income) and creation of *loan loss provisions* (they increased by 25% on annual basis).**

  however,
- **capital adequacy ratio (12,6%) i*ncreased* by 1.4% during year 2009,(min. level 8%)**
- **good l*iquidity* position (e.g. loans to deposit ratio was 77%) and *manageable market risk.***

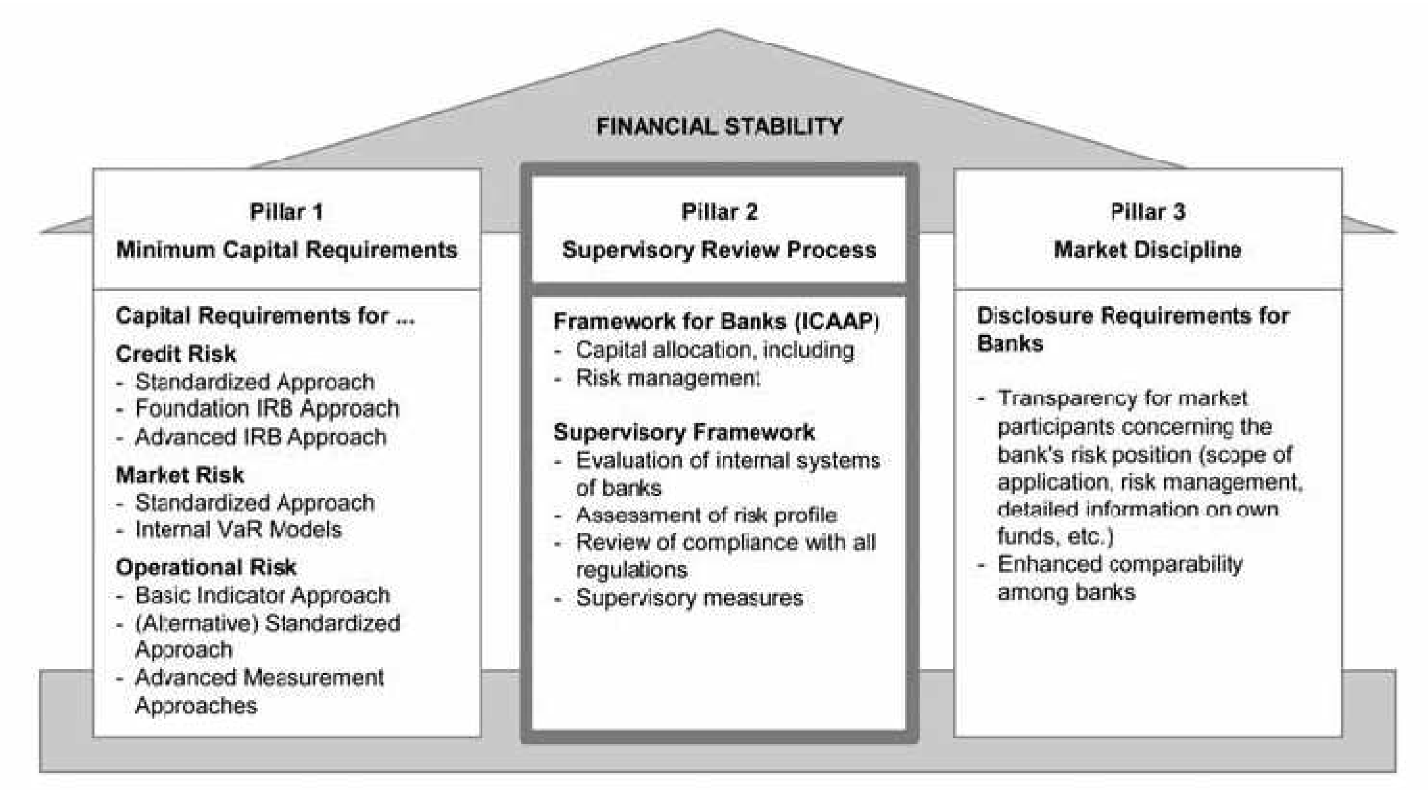
II. Banking Regulation as a Contributor to Key Success Factors...

- **The bank *risk management system* and financial institution *regulation* have been identified among the key issues of the current financial crisis**
- “Many business people pay lip service to Sarbanes-Oxley, Basel II, and ERM. In their hearts, they believe the processes required by all three were designed by bureaucrats, professors, or regulators who do not really understand risk“.

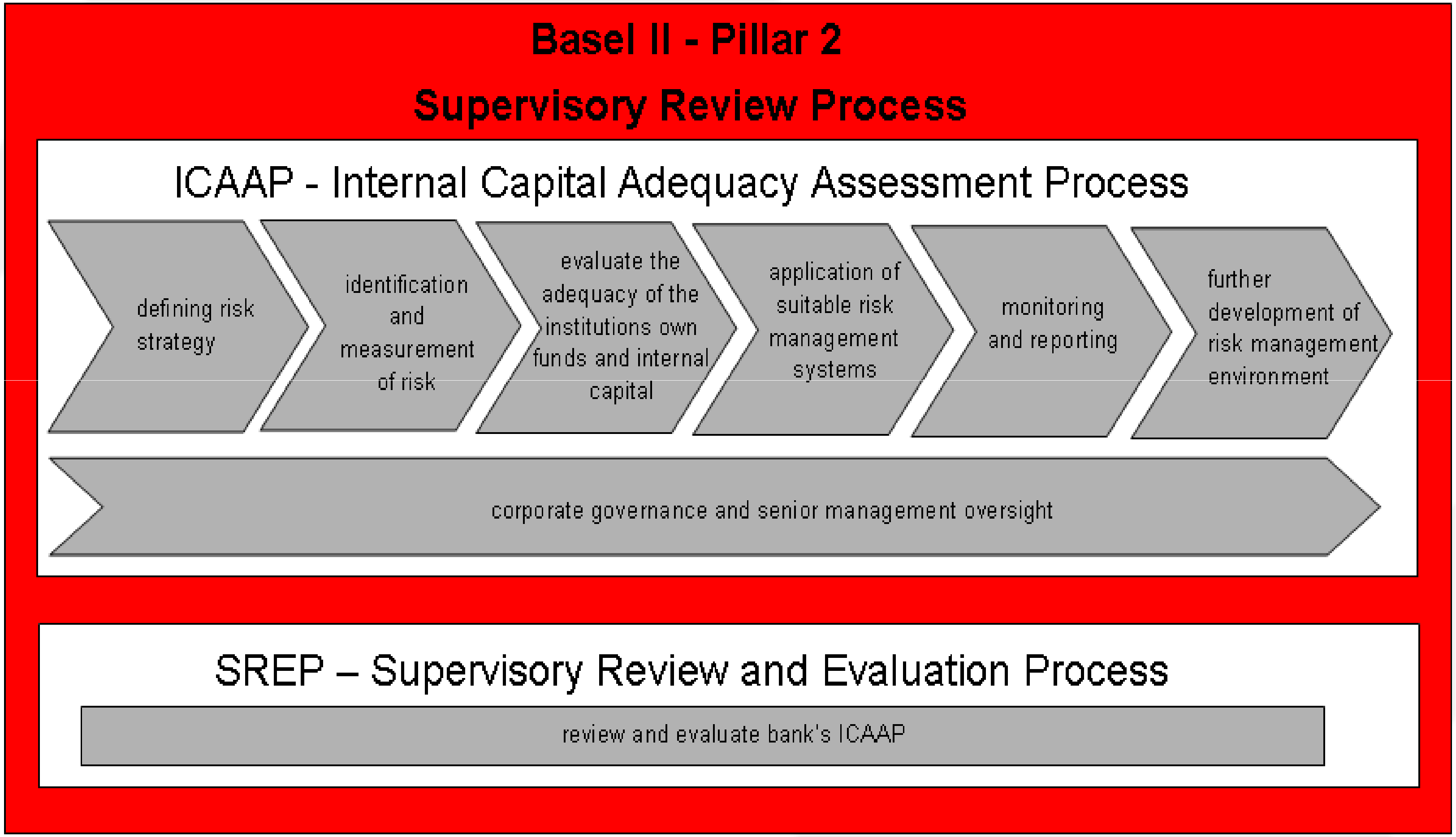
In:Hampton, J. John: Fundamentals of Enterprise Risk Management. How top companies Assess Risk, Manage Exposure and Seize Opportunities. AMACOM 2009, p.240

- **Our opinion regarding Basel 2 is different**: we have identified that Basel 2, Pillar 2 is useful regulatory framework and if is fully implemented in line with Basel 2 principles it could avoid many commercial bank problems which poped-up during crisis.

II. Banking Regulation as a Contributor to Key Success Factors... Basel 2 Architecture



II.Banking Regulation as a Contributor to Key Success Factors... Pillar 2



III. Key Success Factors in Downturn Market

Three Groups…

- **1. Bank *Operates under Risk Management System* (with high level of I.T. support) which Fulfills either *Basel 2* Requirements or the Best Practices of Enterprise Risk Management *(ERM) System*.**

- ***2. Bank Governance Bodies* Involvement and Readiness to Widely Support Changes in the Bank Management due to Downturn Market.**

- **3. *CRO Leadership Role* and *Key Risk Management Activities* during Downturn**

III. Key Success Factors in Downturn Market
1. Bank *Operates under Risk Management System* (with high level of I.T. support) which Fulfills either *Basel 2* Requirements or the Best Practices of Enterprise Risk Management *(ERM) System*.

- **Banks that have systematically built risk management system** are able to apply for *internal risk based systems* (foundation or advanced) to individually calculate minimum capital requirement on their credit portfolio and implement easily *Pillar 2 (ICAAP*) within Basel 2 framework.

- There is also ***widely spread attitude*** of some bankers towards ICAAP as „mainly“ regulatory request not something which could the commercial bank risk management benefit from.

- But there are practical experiences/ evidences if bank operates under ICAAP it has an excellent technical support framework both for *modeling* of internal capital needed for individual risks and their **integration** (applying diversification effects). All-in (including risk culture which usually is built-in these types of institutions) ***are very important assumptions to manage risk during downturn correctly*** as at that time commercial bank risk management gets really complicated**.**

2.The Bank´s Governance Bodies Involvement and Readiness to Widely Support Changes in the Bank Management due to Downturn Market

Key ***drivers***:

- a/ Bank Governance Bodies are involved from the **beginning in the process of changes** to prepare bank in advance for a new situation. Their key role and responsibility in relation to **general managerial** areas are:
- **. to approve** newly projected **risk profile and risk taking capacity** expected due to new conditions (acceptance how much risk is the bank willing/ able to accept in line with shareholder's appetite and own capacity).
- . **to communicate newly expected risk profile and risk taking capacity to key shareholders** to know their risk appetite and readiness to support it by capital, if needed. **Important part** of this communication is to negotiate with shareholders potential changes in **goals and targets** of the bank.
- . **to launch process of changes and approval managerial documents (Bank Strategy/Budget and KPI** s) to reflect a new risk profile (parameters) and capacity if market conditions are changed or are expected to be changed significantly and key managerial documents don´t reflect them.
- .to ensure that all approved documents are **correctly communicated throughout the whole bank and truly** implemented to **minimize strategic and business risks.**
- . to **ensure clear alignment of risk and business models**. The **leadership role of CEO** and the governance bodies are inevitable mainly if institution hasn't operated in this mode before downturn and senior leadership team responsible for business is reluctant to this alignment.
- **.Risk adjusted performance measurement system based on a newly created managerial documents** and consistently implemented through all managerial levels of the bank is important factor to ensure risk and business models alignments in practice.
- **.** to **oversee risks without owners** but with high importance for the bank: strategic, business, reputational, horizon.

2. The Bank´s Governance Bodies Involvement and Readiness to Widely Support Changes in the Bank Management due to Downturn Market cont.

- b/ **To ensure and underline leadership role of Chief Risk Officer (CRO) and Chief Financial Officer (CFO) in key areas of importance -** in the capital management and risk management.

- c/ **To support and ensure strong independent position of risk management unit (in line with its mission)** not only formally (via organizational chart required by valid legal acts) but also informally to declare ***risk culture*** in the bank.

3. *CRO Leadership Role* and *Key Risk Management Activities* during Downturn

CRO and his/her **team** are one of the **key success factors** if:

- . **CRO is authority accepted by the others (including CEO and Board of Directors**) due to his/her ***personal characteristics*** (strong personality with high level of integrity…), ***communication skills*** but also ***professional capabilities*** and ***capabilities to encourage others*** to accept risk management ***mission.*** He/she has to be ***flexible*** and able to manage under high ***level of uncertainty*** and should be ***rather conservative than liberal*** (mainly in decision on expected risk parameters , provisions, minimum level of capital, capital cushion etc.).
- . ***CRO behaves very transparently and has in mind "corporate social responsibility***" of his/her institution when does or proposes risk management solutions.
- . ***CRO has a clear vision, own strategy and plan how to review the whole risk management system,*** to identify key risk drivers at each phase of the risk management process and their impact on the bank' s risk profile and risk taking capacity. In this way he/she has to act as a ***coordinator*** of a numerous tasks and activities run by his own staff and closely cooperating units**.**

- **. risk team** is both from professional and motivation sides ***able to assess impacts of the new***
- ***environment on risk types and exposures they*** are responsible for and is also able to propose alternatives to mitigate them.   CRO ***must assess team capabilities*** from those perspectives, to fix discovered weaknesses and encourage and support team to work under new circumstances.
- **.** ***CRO adjusts reporting system*** to serve his/her needs in downturn market.
- **.** Simply saying he/she is both a **good leader and manager**

3. *CRO Leadership Role* and *Key Risk Management Activities* during Downturn cont.

Key Risk Management Activities:

a/ Review, adjust and communicate Risk Management *Mission* to reflect appropriately new circumstances.

b/ To review/set up process to *regularly scan external and internal environment* with aim to identify, measure and mitigate impact of discovered changes on the bank’ s risk profile and risk taking capacity and to *minimize horizon risk (potential conflict of business people and risk before external changes of environment are materialized)*. This must be a permanent process: it is never known which risk can pop-up or change its importance during downturn.

c/ CRO Main Attention (*Priority)* Put on the Risk Types Heavily Influenced by Downturn: *Credit Risk*

***d/* CRO and its role in Managing the Other Commercial Bank Risks during Downturn: da/ risk under direct CRO responsibility – operational, market, liquidity. db/risks without risk owners-strategic risk, business risk, horizon risk, reputational risk, etc.)**

Mission and Goal of Risk Management Unit

Proactive Approach to Risk Management under Global Financial and Economic Crisis!!!

Mision of the Risk Management: a/ to set up quidelines (policy, limits), b/ to identify, measure, monitor and report **LEVEL OF**:

Other risks: e.g.
- *Strategic risk*
- *Business risk*
- *Real estate risk*
- *Reputational risk*

Credit risk

Integrated risk

Operational risk

Market risk including liquidity risk

for

a) Individual transaction / standalone risk
b) portfolio

through application of relevant

a) risk models / tools
b) risk processes

- risk / return value
- the amount of economic capital

With **goal** to mitigate potential losses and identify new business opportunities

to add SUSTAINABLE value to shareholders

to be in compliance with regulatory requests

3. *CRO Leadership Role* and *Key Risk Management Activities* during Downturn.

Key Risk Management Activities

c/ CRO Main Attention (*Priority)* Put on the Risk Types Heavily Influenced by Downturn: *Credit Risk*

- to review **credit risk strategy and propose its adjustment** .

  Two main behaviors of the Slovak banks were identified

  - banks **with aggressive credit risk strategy in the past** (they were focused primarily on loans growth through fast market share acquisition both in corporate and retail segments). **Strategy in the downturn**: **radical stop in loan expansion (strict risk parameters adjustment, exposures decreasing) – credit crunch with serious macroeconomic impacts and threats also for customers who were temporarily influenced by downturn.**

  - banks **with conservative credit risk strategy in the past** (they were focused on steady loan growth through retention of existing customers and acquisition of new ones with better ratings and applying stricter product credit parameters).

    Strategy in the downturn: **banks only moderately adjusted their credit risk strategy and continued to do "business like usually". It is a case when risk management (in line with its mission) discover and support business opportunities in the market.**

3. *CRO Leadership Role* and *Key Risk Management Activities* during Downturn.

Key Risk Management Activities

c/ CRO Main Attention (*Priority)* Put on the Risk Types Heavily Influenced by Downturn: *Credit Risk*

- **Comprehensive credit risk management review *both on aggregated and single transaction levels.***

Credit risk management assessment on an *aggregated level*

- *areas of focus on aggregated level**: credit risk policies and credit portfolio monitoring.***

  Critical success factors: agreement on changes is achieved among senior management team members (mainly business and risk areas) and is ***apropriately communicated*** to the lower levels throughout the bank.
- ***c*redit portfolio development monitoring.** In addition to a regular credit portfolio review CRO must ensure to monitor credit portfolio mainly from

  industrial and single exposure concentrations points of view

3. *CRO Leadership Role* and *Key Risk Management Activities* during Downturn.

Key Risk Management Activities

c/ CRO Main Attention (*Priority)* Put on the Risk Types Heavily Influenced by Downturn: *Credit Risk*

***Single transaction* credit process screening and CRO role.**

At *each credit process phase* there are events typical for downturn which ask for CRO involvement and fixing.

- ***Underwriting***
  - **to solve higher pressure from business people on risk managers...**
  - **fraudulent documentation and data** occur more frequently...
  - review **credit rating/scoring models.**

- ***Credit Risk Mitigation***
  - to ***review risk mitigation*** means and processes to ensure ***higher recovery rate***.
  - Banks which operate under ***IRB approaches*** are in better position as they had to pass strict regulatory assessment proces focused also on credit risk mitigation

- ***Monitoring***
  - ***Adjustment of the EWS from external and internal sources of information is important***

3. *CRO Leadership Role* and *Key Risk Management Activities* during Downturn.

Key Risk Management Activities

c/ CRO Main Attention (*Priority)* Put on the Risk Types Heavily Influenced by Downturn: *Credit Risk*

***Single transaction* credit process screening and CRO role.**

At *each credit process phase* there are events typical for downturn which ask for CRO

- ***Work-out***
  - to review ***work-out capacities and strategic alternatives* to propose the best solution (cost/benefit analysis).** There are two possible options : ***a/ in-house solution*** – this option is prefered by banks with majority of corporate and mortgage portfolio. ***b/outsourcing of work-out activities*** - this option is typical for retail banks portfolio.

Conclusion

- Recent financial crisis **encouraged world-wide discussion** what to do to minimize financial crisis occurrence in the future.

- **our opinion is that Basel 2, Pillar 2 principles can serve as a good guideline** to set up such commercial bank´s risk management system which (if is fully developed and implemented) can be helpful tool for the correct bank management during downturn.

- However, it is equally important to **identify key factors and measurements** on the **level of each commercial bank** which could allow fully exploit feature of the risk management system built on Basel 2, Pillar 2 principles.

- **Identified key success factors (coming from the last crisis experiences) can also serve** as a basis for **further discussion how to built efficiently operating commercial bank risk management system** which could serve both for prevention of crisis situation and also for management if crisis occurs.

Thanks for Your Attention