Strategic Risk Management and Balance Sheet Management under the new regulatory environment

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Moody's Investors Service

Moody's Analytics

Economic & Consumer Credit Analysis
Credit Research & Risk Measurement
Structured Analytics & Valuation
Enterprise Risk Management
Enterprise Risk Management Solutions

Enable you to combine cutting-edge quantitative credit and portfolio analytics with world-class software to manage risk and performance

Modular and Integrated Approach: Use individually or integrate our solutions to fit your specific needs
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Global Presence
- Teams are based globally throughout the globe (SF, LN, HK, SZ, SG)
- Provides 24-hour support to urgent projects and allows the teams to leverage off international experience and best practices

Industry Experience
- Works with and maintains strong relationships with many financial institutions and regulators globally

Implementation Experience
- Has implemented risk management systems at >100 institutions
- All teams have strong project experience to mitigate project risk and ensure efficient project implementations

Leading Research & Data
- Works closely with Moody’s KMV Research to ensure the latest research insights are passed to all clients during the project
- Large source of economic and risk data to help build robust models
Regulatory views on Strategic risk management
“….Senior management understands the risks involved; assessing potential returns without fully assessing the corresponding risks to the organization is incomplete, and potentially hazardous, strategic analysis”

Notably, the ongoing fundamental transformation in financial services offers great potential opportunities for those institutions able to integrate strategy and risk management successfully.

Governor Randall S. Kroszner - FRB – US
Strategic risk” means the risk of current or prospective impact on an FI’s earnings, capital, reputation or standing arising from changes in the environment the FI operates in and from adverse strategic decisions, improper implementation of decisions, or lack of responsiveness to industry, economic or technological changes”.

Hong Kong Monetary Authority in SR-01 Supervisory Manual – Dated 12.12.07
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Strategic Risk and Linkage with Risk Appetite
Strategic Risk and Risk Appetite are conversely two sides of the same coin

**Strategic Risk**

Aspirational

“Risks that may **induce** current or future negative **impacts on the financial, reputation** and market **positions** assumed because of **poor strategic decisions, improper implementation of strategies** and lack of **response to the market** based on its **operational strengths**

**Risk Appetite (Discovered)**

Inspirational

It is the **basic capacity to assume risks** at the organizational level given the **configuration of macroeconomic constraints, banking supply chains and configuration of operating constraints**.
Strategy and Risk integration is possible by linking risk appetite and strategic risk management

- Refers to positioning of the Bank
- Refers to action/response to the market
- Refers to lack of awareness of balance
- Awareness of risk appetite, in a true sense, will help the organization to balance its risk taking propensity with its real income growth.
4

Changing regulatory landscape due to Basel III
Basel III Timeline is stringent and does not offer much room for maneuvering

Banks forced to reevaluate their strategy as leverage ratio of 3% comes into force

Banks forced to rethink their balance sheet in order to meet leverage ratio and NSFR

Banks need to balance their aspirations with the regulatory constraints/costs in short term to meet LCR and Capital requirements
Increasing regulations especially Basel III are putting pressure on bank’s earnings and are revisiting strategic aspirations.

- **Common equity to a 7% common equity tier I ratio for major banks globally is** EUR 486 billion.
- **Shortfall to the LCR** EUR 1.8 trillion.
- **Banks having LCR below 75%** 40%.
- **Shortfall to the NSFR** EUR 2.9 trillion.
- **Banks would not meet the 3% tier one leverage ratio** 33%.
- **Percentage of Banks from the region who formed part of QIS exercise** 33%.
Strategic risk management and Risk Return Optimization becomes even more critical in the light of changes.
Balance Sheet Management needs an enterprise level view similar to strategic planning in the organization.
Operational framework for Strategic Risk Management requires evaluation of all risks on the strategic horizon of the Bank.

What Can Go Wrong that deflects the Bank from its vision?
Strategic Risk Framework requires basic discussion at the Board level – Sample Illustrated template

<table>
<thead>
<tr>
<th>Sr No</th>
<th>Strategic Risk</th>
<th>Owner (Please provide the name and title of the owner)</th>
<th>Risk Mitigation Approach *</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Disciplined credit growth not achieved</td>
<td></td>
<td>Mitigate</td>
</tr>
<tr>
<td>2</td>
<td>Inability to detect downside risks timely</td>
<td></td>
<td>Monitor</td>
</tr>
<tr>
<td>3</td>
<td>Acquisition and alliance strategy not achieved</td>
<td></td>
<td>Delay</td>
</tr>
<tr>
<td>4</td>
<td><em>Expected benefits from transformation not realized</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td><em>Inability to innovate and offer competitive products and services to satisfy customers needs</em></td>
<td></td>
<td>To be filled at a later stage</td>
</tr>
<tr>
<td>6</td>
<td>Inability to realize value from investments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Reputation and Brand damage due to poor customer service or mis-selling</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Non traditional entrants offering banking services</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Strategic Risk – Evaluation of Risk Appetite
Lifecycle – From Definition to Operationalization

Phase I - Discover and articulate risk appetite in accordance with strategic plan
Phase II Approve Risk Appetite
Phase III – Approval of strategic risks
Phase III – Evaluation of strategic risks
Phase IV – Operationalization of risk appetite

Definition by the Board and CEO
Validate and Confirm
Institutionalize
Permeate

Suggested Management levels
Board
CEO/ Senior Management
Staff level

Mitigation
Board Endorsement
Balance Sheet and Strategic Risk management provides the link between Strategy and Risk Appetite.

What impact will an adverse scenario have on your ROA?

ROA and Risk Appetite are linked in your planning as ROA is the result of the sum of investment decisions.

Setting an appropriate Risk Appetite can impact your overall business strategy and allow you to be prepared to respond to adverse scenarios.
Understanding risk profile and priorities of the Board and the Senior Management through facilitation

GROWTH

1

BALANCED BUSINESS MIX

Growth

Capital Conservation

2

TARGETED BUSINESS MIX

Balanced Business

Targeted Business

3

4

CAPITAL CONSERVATION
Understanding the territories of the strategic risk and strategic planning exercise

GROWTH

TARGETED BUSINESS MIX

BALANCED BUSINESS MIX

CAPITAL CONSERVATION

Balance Sheet Diversification, Capital & Liquidity Constraints

Higher Capital Needs, Tail Risk, Funding Volatility, Cyclical Earnings

 Structural Funding Diversification, Shorter Maturities, Lower RAROC

Balance Sheet Concentrations, Capital Volatility

Constraints
Reviewing Balance Sheet in a holistic way can balance firm’s strategic aspirations with risk.

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>Fixed Assets</td>
</tr>
<tr>
<td>Debt</td>
<td>Investments</td>
</tr>
<tr>
<td>Deposits</td>
<td>Loans</td>
</tr>
<tr>
<td>- Retail</td>
<td>(Retail/ Corporate/ SME)</td>
</tr>
<tr>
<td>- Corporate</td>
<td>Cash (Bank balances)</td>
</tr>
</tbody>
</table>

**ICAAP**

**Basel III**

**EC considerations / stress testing**

**Liquidity Risk**

**Modeling for deposits/ Cost of Hedging**

Off Balance Sheet considerations

<table>
<thead>
<tr>
<th>Cost of Funding Considerations</th>
<th>Income Drivers</th>
</tr>
</thead>
</table>

Basel II Pillar II capital / III/ Liquidity buffer
EC considerations or AIRB/ FIRB
Strategic Risk Management Decision-Making: How much Sensitivity are You Willing to Take in your Balance sheet?

GROWTH

1. Growth
2. Capital Conservation
3. Balanced Portfolio
4. Targeted Portfolio

CAPITAL CONSERVATION

BALANCED PORTFOLIO

TARGETED PORTFOLIO
Quantifying strategic risks provides an impetus for Balance Sheet Management
Balance Sheet Sensitivity with Financial Performance Metrics; Quantify the Strategic Impacts

1. Define Your Risk Appetite Within the Strategic Planning Framework

2. Analyze the Sensitivity of Your Financial Performance Metrics

*Bubble size quantifies the institution’s risk appetite sensitivity*
Risk Appetite Sensitivity Analysis: Understand How Resilient Your Balance Sheet Is Under Different Scenarios; Identify Vulnerabilities (Cont.)

Local Depression Scenario – Strategy A

Global Depression Scenario – Strategy A

*Lobules quantify the performance metrics sensitivity to a given strategy*
ScenarioAnalyzer™ Provides an Unique, Single platform to Analyze the Risk Appetite Holistically at the Enterprise-wide Level After Consideration of Strategic Initiatives and Business Planning

ScenarioAnalyzer™ Shows the Strategy Impact on Sales Growth, Operating Margin, and other Performance Indicators

ScenarioAnalyzer™ Generates a Set of Customized Balance Sheet forecasting reports to Review, Report, and/or Re-define the Institutions’ Risk Appetite

ScenarioAnalyzer™ Allocates the Risk Appetite Sensitivity and Balance Sheet Risk Profile By Scenarios, Geographies, and Products
Strategic Risk Framework

1. Board approve high-level approach to strategic risk

2. Risk work with senior management to identify the planning cycles and create tools for risk identification

3. Risk Identification for strategic risk can be based on a facilitated workshop delivered for Board and Senior Management

4. Strategic risk considerations identified as part of material risk assessed separately

5. Strategic Risk Assessment can be measured in its impact to Earnings at Risks caused by strategic impact

Practical considerations and challenges:

» Strategic risk can be quite subjective and therefore it needs to be aligned with the firm’s objectives

» Strategic risk works best with the top down approach

» Strategic risk might have overlaps with credit and operational risks or other risks but the context for such risk identification needs to be established

» Macroeconomic projections on a long term needs to be benchmarked to industry wide benchmarked data

» Facilitated workshops/ questionnaire for strategic risk identification and assessment may require extensive ground work and research
Thank you

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