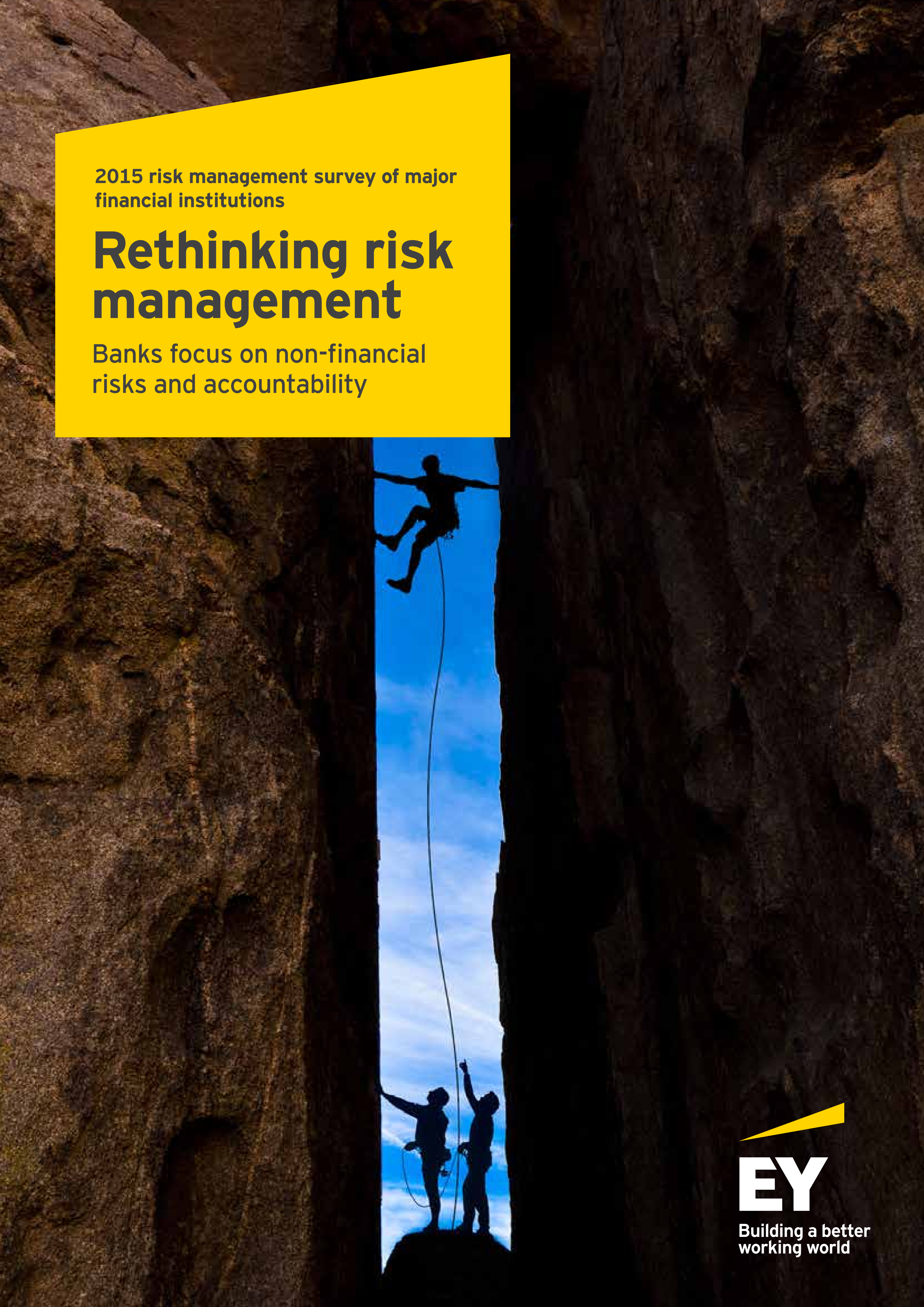
2015 risk management survey of major financial institutions

Rethinking risk management

Banks focus on non-financial risks and accountability



Building a better working world

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Executive summary

Rethinking risk management is the sixth annual study of risk management practices conducted by EY in cooperation with the Institute of International Finance (IIF) since the financial crisis. A total of 51 firms across 29 countries participated in this year's study. The five previous surveys delivered a clear picture of the industry moving steadily year by year to enhance risk management systems and processes to meet regulatory and market demands for tightened controls and prevent a future crisis from occurring. This year's survey sees further consolidation of those changes but also the start of a process to re-engineer some aspects of risk management, one requiring new approaches and tools.

A consistent theme in this year's survey is the degree to which firms are rethinking their approach to managing non-financial risks and risk accountability. Recently uncovered conduct and compliance failures have resulted in huge financial and reputational costs to the industry, and nearly two-thirds of survey participants agree that lapses in internal oversight and controls are the main reasons for these losses. Study results point to several key initiatives under way to improve risk management and risk behavior:

- **New treatment for non-financial risks.** Firms are now looking at non-financial risks in a more granular way — by sub-risk types such as conduct, compliance, reputation, money laundering and systems. An increasing number are treating conduct risk as a principal stand-alone risk type and devoting significant time and resources to redefining policies, procedures and metrics to manage and monitor it.
- **Forward-looking versus after-the-fact analysis.** Over half of the participants are working to develop more forward-focused assessments and prevention rather than after-the fact analysis of a risk failure, and many are enhancing scenario analysis and tools to better assess forward non-financial risk. This is akin to a financial-risk mindset, which aims to identify credit and market risks and anticipate their effects. To spur the change, a number of banks are moving the compliance function under the risk function.

- **Increased accountability of businesses.** The importance of assigning and monitoring accountability has emerged over the past year as a key factor in non-financial risk management. Ninety-four percent of this year's respondents now hold the front office — desk heads and business-unit heads — fully accountable for managing a wider view of risk, including non-financial risks, such as conduct and reputational risks, in their areas.
- **New processes to manage conduct risk.** Given the heightened regulatory, public and board attention to misconduct in the industry, conduct risk management is a high priority. On a fundamental level, many reported work to identify and reduce intrinsic risks inherent in their current business models. These include exiting certain markets and types of products, changing incentives and adjusting revenue and sales targets. Products and customers are both areas of greater attention, and many firms have implemented new product development approval and oversight processes and improved customer-facing activities.

It has become increasingly apparent that having a strong firmwide risk culture is one of the key components of successful risk management, and both regulators and boards are demanding significant enhancements to governance, structure and controls in an effort to improve risk behavior. As a result, there has been an intensified effort across the industry over the past several years to review and assess current processes and procedures and implement changes to proactively and effectively manage the culture. Seventy-seven percent of survey respondents reported an increase in senior management attention to risk culture in the past 12 months, a considerable increase from the previous two years. And 75% report they are in the process of changing their culture. A key driver behind these changes is the effort to achieve alignment and integration of all the elements that ultimately affect behavior, including risk appetite, accountability, performance management, compensation, hiring and training.

In last year's study, we reported some significant changes under way around risk governance. Many firms were in the process of adding new board and senior management committees to oversee and monitor ethics and conduct and were streamlining and integrating current committees to break down silos. This year, firms are "buckling down" to implement and refine the changes initiated last year. On other fronts, firms are still finding it difficult to translate the firmwide risk appetite strategy into the day-to-day planning and operations of their businesses, and the majority continue to work to improve stress testing approaches and enhance data and systems.

And finally, the changes implemented as a result of Basel III have been important for many banks. While most of the firms in this year's study have completed, or are close to completing, their systems and processes to comply with the Basel III requirements, the impact of the mandated changes on strategy, cost structures and profitability are still reverberating throughout the industry. Rising costs and decreasing return on equity (ROE) are driving much of the change. Almost 80% of respondents report that investors are not accepting the lower ROEs and are putting pressure on them to improve performance and increase returns, and many firms are continuing to adjust their business models in an effort to do so while addressing risk issues at the same time.

Strengthening the risk culture continues to be top of mind

Given the number of conduct failures across the industry and the intensified pressure from regulators, there has been a major industry-wide effort over the past few years to alter risk culture. Firms are approaching this from at least three directions: further strengthening risk governance and, in particular, shifting accountability for risk into the front office and ensuring the front-office controls are in place and effective; clarifying the range and magnitude of acceptable risk using an embedded risk appetite statement and various forms of messaging and training; and more closely aligning incentives with risk objectives and establishing how breaches in rules will be viewed and handled. However, much of this is still work in progress.

Executives agree that the key ingredients for creating a strong risk culture must include direction and "relentless" communication from the top of the organization; a strong risk appetite that is embedded into business strategy and planning; clearly defined roles, responsibilities and accountability; and strong consequences for misbehavior through performance management, compensation and disciplinary actions. For many firms, making risk everyone's business, from the top ranks down to the front-line staff, represents a significant shift in mindset, policies, systems and processes and requires an ongoing, long-term commitment and investment.

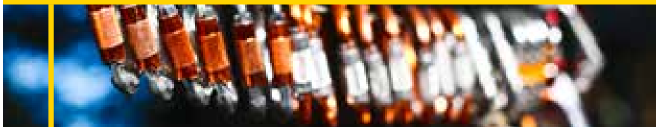
- **75%** of banks are making changes to their culture, and **81%** say that cultural change is still very much a work in progress.
- Only **44%** say that individual behavior is significantly reflected in career progression, and only **42%** believe that it is completely understood that negative behavior will be penalized despite earnings performance.
- However, **94%** report that severe breaches to the firm's risk policies do result in disciplinary actions.
- **46%** say that messages not cascaded effectively throughout the organization are a major cause of the breakdown in risk culture.

Non-financial risks, particularly conduct risk, are another top concern

Almost all banks have increased the focus on non-financial risk, and many are now looking at it in a more granular way — by sub-risk types such as conduct, compliance, reputation, money laundering and systems. Losses from non-financial risks have been high for many firms, particularly global systemically important financial institutions (G-SIFIs), reflecting the size of fines and remediation costs, and the majority of this year's study participants cite lapses in oversight and controls as a key internal factor that has contributed to these loss events. As a result, most banks are enhancing operational controls and processes to identify control weaknesses. In many firms, this is an intensification of existing processes. But some banks are also developing new tools and techniques to understand and track the intrinsic risks more effectively. Firms are increasingly focusing on forward-looking risk assessments and prevention versus after-the-fact analysis of a risk failure, and many are enhancing scenario processes and tools aimed at more effective assessment of forward risk.

Given the heightened regulatory and public attention to misconduct in the industry, conduct risk management is a high priority. Many participants reported activities to identify and reduce intrinsic risks inherent in their current business models, including dropping products and exiting markets, changing incentives and adjusting revenue and sales targets. Additionally, many have implemented new product development approval and oversight processes and improved customer-facing activities. Many agree that an essential part of the solution will be a fundamental shift to the front office of accountability for all risks, including non-financial ones. In many banks, the business lines are notionally responsible for all risks, but there are no structures to enable them to exercise that responsibility, and generally, de facto accountability sits in the control functions.

- **89%** report increased board and senior management attention to conduct risk.
- **64%** cite weak oversight and controls as main causes of loss events.
- **94%** say the front office and business heads are responsible for day-to-day management of risks. However, major programs are under way in a number of banks to make this accountability more meaningful.
- Enhancing risk assessment of conduct risk (**67%**); increasing focus on new products (**62%**); increasing business-line accountability (**60%**); strengthening the second line of defense (**56%**); and increasing focus on new customers (**38%**) are among key focus areas.



Banks continue to struggle to embed risk appetite across the enterprise

Despite the fact that risk appetite has been a top area of focus for both boards and chief risk officers (CROs) over the past several years,[1] many firms are still finding it difficult to translate the firmwide risk appetite into day-to-day business decisions. While there is a strong regulatory push behind strengthening risk appetite frameworks, firms are also seeing real benefits in using the process to provide a unified view of risk and mechanisms against which individual decisions can be tested. The industry is reaching a consensus on the top-of-the-house metrics used to set and monitor risk appetite, with the majority using some form of forward extreme-loss metric. The next stage will be setting risk appetite for non-financial risk types; this has already started.

Effectively cascading the risk appetite through the operational levels of the organization remains the top challenge to implementing risk appetite. Executives agree that embedding risk appetite requires attention to all of the activities discussed throughout our report: shifting the cultural mindset around risk; strengthening governance structure roles and responsibilities; adjusting performance requirements and compensation; and upgrading systems and processes to test, track and assess progress. For most, the process is a long-term effort to develop and implement, and sustaining it over time will be an ongoing journey.

- Only **43%** say they have successfully integrated risk appetite into the businesses (a slow but steady increase over previous years).
- **70%** report a significant linkage of risk appetite with business planning, but only **43%** say the day-to-day decisions are "largely tested" against risk appetite.
- **57%** report strong progress in their ability to track and enforce risk appetite.

[1] For example, risk appetite has been extensively covered in industry reports such as the July 2008 *Final Report of the IIF Committee on Market Best Practices,* the December 2009 IIF report *Reform in the Financial Services Industry* and the June 2011 IIF report *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions.*

Risk governance structures are being strengthened; risk compliance has risen to the top focus area for boards and CROs

The exposure of conduct failings in many banks is influencing the structure of risk governance up to the board level. Banks have added new committees at both board and management levels to monitor conduct and ethics, and some firms are shifting responsibility for compliance to the CRO and risk function. Banks are streamlining governance structures to break down silos and close the gaps in risk oversight and control, as well as strengthening their three lines of defense models for risk governance[2] to further clarify the division of responsibility and accountability, in particular, to make the front line clearly responsible for risks related to their activities. Firms have made changes to their boards to increase areas of expertise — mainly in risk management and banking.

However, reflecting the continuing regulatory pressure, firms report a considerable increase in both board and CRO attention to regulatory compliance.

Many discussed the difficulty in striking the right balance between managing risk and managing regulations. All agree that incorporating regulatory requirements into the strategy and day-to-day operations of the business is difficult, and many CROs worry they are being pulled more and more into the role of "chief regulation officer" at the expense of devoting attention to risks as they affect the business.

- Compliance risk (**57%**) followed by risk appetite (**47%**) and credit risk (**32%**) are top areas of focus for boards.
- Regulatory compliance (**61%**), risk appetite (**59%**), credit risk (**57%**) and operational risk (**48%**) are listed as top areas of attention for CROs.
- **64%** report increases in the size of the risk function over the past 12 months, and **60%** expect such increases to continue next year.

[2] Under the three lines of defense model, operational risk management is divided into the first line (which takes/owns and manages the risk — e.g., business areas); the second line (functions that oversee risk — e.g., the risk function); and the third line (functions that provide independent assurance — e.g., internal audit). See the Institute of Internal Auditors' position paper "The Three Lines of Effective Risk and Control."

Banks are working to embed stress testing into business processes

Banks are continuing to improve and refine stress testing methodologies. Many are moving toward a more holistic firmwide stress testing framework to improve consistency and comprehensiveness in measurement across risk types. Firms are trying to move to a position where they can make fully effective use of stress testing as a management tool: they are beginning to link stress testing to financial planning to access balance sheet and P&L outcomes in stress environments. However, the slow turnaround of results and lack of standardization are barriers to effective use of the output, and there is still a way to go to link stress testing to strategic and business decisions. Central departments are being set up to focus on stress testing, but many complain about the sheer amount of time and resources being devoted to the supervisory-led stress tests in some countries, which may occupy resources that could otherwise be used for stress testing firm-identified specific risks.

- **81%** have created new stress testing methodologies in the past 12 months.
- Top areas where stress testing is used include risk management (**96%**), capital planning (**94%**) and risk appetite development and management (**87%**).
- However, **55%** say that stress testing is only "somewhat" incorporated into strategic decision-making.
- **70%** stress internal ratings-based (IRB) models for credit portfolios, and **52%** run central stress testing models.
- **55%** take two months or more to complete a group-wide test impeding use as a flexible management tool.

Basel III regulations continue to drive fundamental changes to the industry

The regulatory changes that have been made and continue to be initiated have had widespread implications for many firms. The industry is facing continuing pressures on business models because of these regulatory changes. The central issue is that with the higher capital and liquidity buffers under Basel III, and with investors pushing back on the resulting lower ROEs, many business lines are now no longer sufficiently profitable. Many banks have exited entire lines of business and are still exiting countries in the continuing retreat back to core markets. One of the goals of the international regulatory reform program is appropriate pricing of risk. As a result, charges for banking products are changing, but the scope for adjusting prices is constrained by competition. International banks are coming under competitive pressure from local banks in some markets and shadow banks in others.

The study points to the continued reluctance of investors to accept lower ROEs, despite the reduction of risk brought about by much higher capital and liquidity buffers. Almost 80% of participants reported heightened pressure from investors to increase ROE, and three-quarters reported pressure to reduce costs. Given the necessity to change risk culture and reduce conduct risks, as well as the extensive IT requirements of regulatory reform, the pressure to reduce costs creates tension. Initially, the reaction to the sizable conduct losses was to add many thousands of new compliance staff across the industry. But this cannot be the ultimate solution. There has to be a shift to better approaches and tools to reduce conduct risks in a more effective way.

While many firms believe they have now adjusted their systems and processes sufficiently to meet Basel III and other new regulatory requirements, the complexities and uncertainties of the global regulatory environment and its ultimate impact on the industry remain a challenge.

- Changes to business models include shifting out of less liquid instruments (**46%**); exiting lines of business (**43%**); streamlining legal entities (**35%**); and exiting countries (**22%**).
- **87%** continue to evaluate portfolios.
- **55%** say Basel III will have a significant impact on costs, and **49%** target lower ROEs of between **10%** and **15%**.
- **79%** say investors are pushing for increases in ROE.

Research methodology and demographics

From February 2015 through May 2015, in cooperation with the IIF, EY surveyed IIF member firms using two methods. The top (by asset size) IIF member banks in each region were approached to take part and an online quantitative survey was distributed to those participating. The team then conducted telephone interviews with the CROs and other senior risk executives of many of the largest global firms. A total of 51 firms across 29 countries participated in the study either online, by telephone, or both.

Participating institutions

Africa/Middle East	Asia-Pacific	Europe	Latin America	North America
Arab Bank	ANZ	Banco Santander	Banco de Crédito del Perú	Bank of Nova Scotia (Scotiabank)
FirstRand	China International Capital Corporation	Barclays	Banco Nacional de Costa Rica	BMO Financial Group
National Bank of Kuwait	Commonwealth Bank of Australia	BBVA	Bancolombia	Canadian Imperial Bank of Commerce
National Commercial Bank	ICICI Bank	Credit Suisse	Itaú Unibanco Holding	CLS
Standard Bank Group	Macquarie Group	Danske Bank	Mercantil Servicios	Goldman Sachs Group
	Maybank Group	Deutsche Bank		Royal Bank of Canada (RBC)
	Mitsubishi UFJ Financial Group	DNB		State Street Corporation
	Mizuho Financial Group	Erste Group Bank		Toronto-Dominion Bank
	National Australia Bank	HSBC		
	Nomura	KBC		
	Norinchukin Bank	Lloyds Banking Group		
	Sumitomo Mitsui Financial Group	Nordea		
	Suncorp Group	Piraeus Bank		
	Westpac	Royal Bank of Scotland (RBS)		
		SEB		
		Société Générale		
		Standard Chartered Bank		
		UBS		
		UniCredit		

Risk culture

Increased attention to risk culture highlights its importance to the industry

Risk culture and its impact on effective risk management have clearly become a top-of-mind issue for senior management. Repeated conduct failures throughout the industry have caused regulators and boards to demand significant enhancements to governance, structure and controls in an effort to improve risk behavior. It has become increasingly apparent that having a strong firmwide risk culture is one of the key components of successful risk management. As a result, there has been an intensified industry-wide effort to review and assess processes and procedures and implement changes to proactively and effectively manage culture.

Attention to risk culture has risen dramatically over the past year (see Exhibit 1). Seventy-seven percent of survey respondents reported an increase in senior management attention in the past 12 months, a considerable increase from the previous year. Perhaps even more striking is the extent of the changes being made by firms around the world. The majority of participants across all regions indicate they are in the process of changing the culture in their organizations (see Exhibit 2), but most (81%) say that these changes remain "a work in progress" (see Exhibit 3). While only 17% believe they have achieved a strong culture, over half (53%) report that they believe they are making progress in changing the culture.

Exhibit 1: Senior executives continue to report an increased focus on risk culture

Exhibit 2: The majority of firms are in the process of changing culture

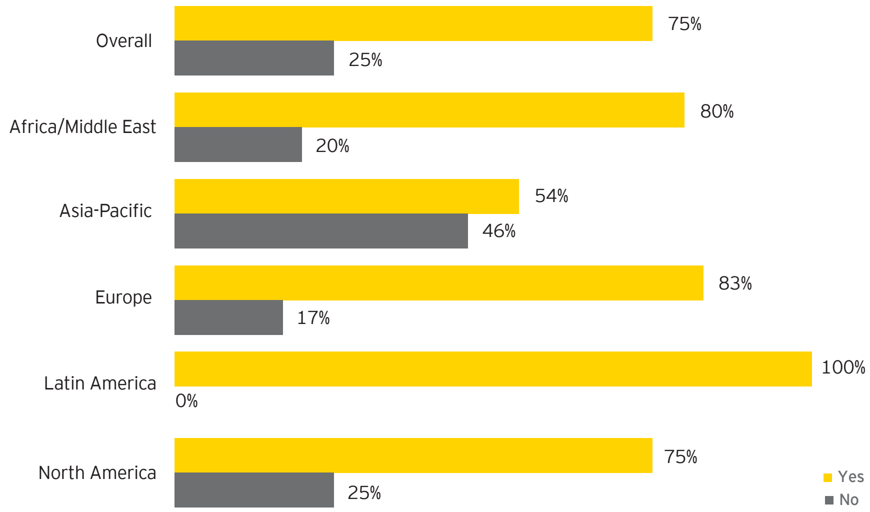
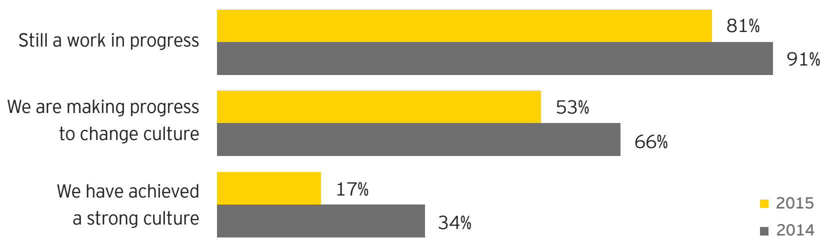


Exhibit 3: The majority say that changing the culture remains a work in progress



The areas of focus, however, differ according to the size and geographic location of the banks. The most intensive and widespread efforts to change culture are taking place within the global SIFI (G-SIFI) community, reflecting the conduct failings seen in this group as well as the magnitude of losses made by some firms during the crisis. The regulatory spotlight falls especially on these large international players. Many are implementing significant firmwide transformation initiatives.

As one executive described his firm's efforts, "We have completely overhauled our enterprise risk management framework, including all of the supporting key risk frameworks and policies; re-evaluated and articulated the firm's culture and values; created a single code of conduct across the firm; and clarified roles and responsibilities, as well as the performance appraisal and compensation process. We have been working seriously on this for years." In contrast, the banks outside the G-SIFI group are focused on refining their culture and conduct policies rather than on widespread programs to change culture. Despite the efforts to date, for almost all banks, changing culture remains a work in progress.

For some firms that have already instituted significant changes, the efforts are now shifting from building to refining and embedding their new programs. As another executive explained, "Now that we have put the big pieces of our new infrastructure in place, we need to shift our focus to determining if it's all working — if the people on the ground are thinking and acting differently."

As can be seen in Exhibit 4, firms cite a broad range of drivers behind cultural change. By far the most important driver (identified by 83% of banks this year, up from 73% last year) is the need for consistency across organizational culture, employee behavior, risk appetite and risk culture. Another driver identified by the majority of banks (67%, up from 61% last year) is the need to align risk culture with risk appetite as a central driver behind change in risk culture. This is an

Exhibit 4: Main drivers behind culture changes

important area of focus by regulators, but it is clear that change is not driven purely by regulatory pressures. Close to one-third of respondents report that board concerns are also driving these initiatives and, for many firms, strengthening the culture is part of an effort to rebuild their reputation in the industry and restore customer trust.

Key success factors to creating cultural change

Based on EY research and discussions with senior executives over the past several years, six critical components have emerged as key success factors to creating and sustaining a strong risk culture:

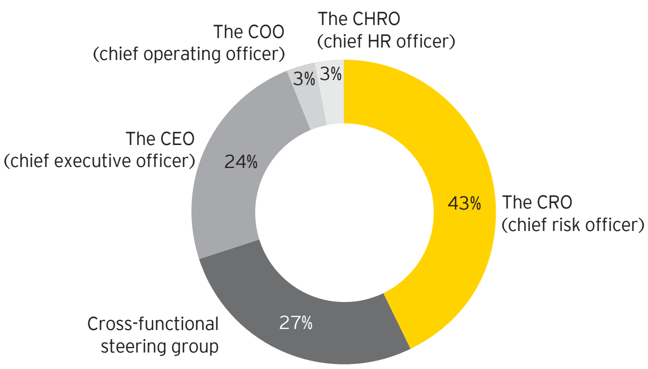
1. Start at the top of the organization
2. Embed risk thinking through risk appetite
3. Clearly define roles and responsibilities and reinforce accountability
4. Enforce the rules
5. Continuously reinforce and instill the culture
6. Assess and monitor progress

Setting the stage for a strong risk culture begins at the top of the organization

Executives agree that both the commitment to a strong risk culture and the development of the tools and infrastructure to build and sustain this culture must be driven by the firm's top executives, and in a number of banks, the initiative is owned quite widely among the senior management group. For nearly half of the study participants (43%), the risk-culture change initiatives are being led primarily by their CRO, while 27% have formed special cross-functional steering committees to lead the effort. For nearly one-quarter of the participants, the CEOs are the main drivers of change (see Exhibit 5).

Another strong message is the importance of a coherent vision for risk culture. The board and senior management team must commit the time and resources to agree on a unified message that ties together "the rules of the road" of what constitutes acceptable risk behavior with the firm's overall vision, values and culture. However, vision alone is not enough. Many of the initiatives discussed in this year's study are centered on aligning and integrating all the elements that ultimately affect behavior — including risk appetite, accountability, performance management, compensation, hiring and training. As one executive described his firm's program, "We have been working to establish a global standards program articulating expectations for entities across the firm to operate at the highest levels. This includes a strong risk appetite framework,

Exhibit 5: Who leads the risk culture change initiative?



reward and assessment programs, remuneration, and control enhancement systems and policies for customer selection, due diligence, sanctions, training and more. Everything emphasizes our commitment to consistent high standards of behavior throughout the firm."

In addition to alignment and consistency of messages and processes, firms are focusing on the management and enforcement of risk behavior. As we reported last year, many firms have made significant changes at both the board and internal management levels to more closely monitor and control conduct risks throughout their organizations. Boards are adding new committees to oversee ethics, conduct and product suitability, and many have created new cross-functional senior management committees responsible for establishing and monitoring firmwide codes of conduct, policies and procedures.

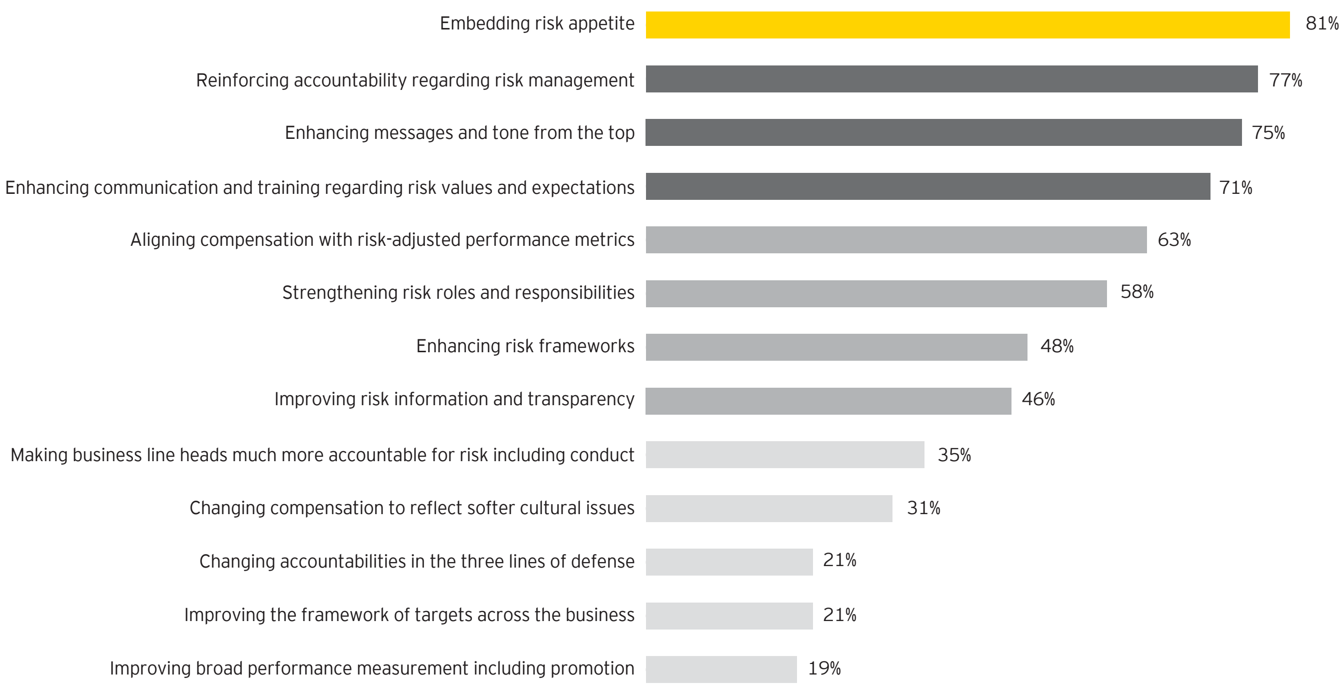
The range of activities necessary to strengthen culture in an effective way comes out strongly in the survey, with six top initiatives cited by more than half of the banks (see Exhibit 6).

Embed risk thinking through risk appetite

Most executives believe a well-articulated risk appetite framework that is effectively cascaded through the organization and reflected in strategy and individual business decisions is the "backbone" to building a strong risk culture. Eighty-one percent of study participants listed embedding risk appetite as a top initiative to strengthen the risk culture (see Exhibit 6). As one executive outlined his firm's effort, "One of our current biggest pilot programs is around our risk appetite. The question we are addressing is how do we revise the risk appetite statement so that we can link it to risk culture, roll it out effectively to the business units and bring it to life for them. How do we make it meaningful in connecting it with what they do day-to-day?"

The majority agree that successful execution of a risk appetite must be a collaborative top-down, bottom-up process. While the board ultimately approves the risk appetite, its development and execution must involve the senior management team — including the business leaders.

Exhibit 6: Top initiatives to strengthen the risk culture



As one executive explained, "The business leaders must believe in and agree with what's on that risk appetite statement and be willing and able to manage to it and monitor it. Otherwise it doesn't work."

Clearly define roles and responsibilities and reinforce accountability

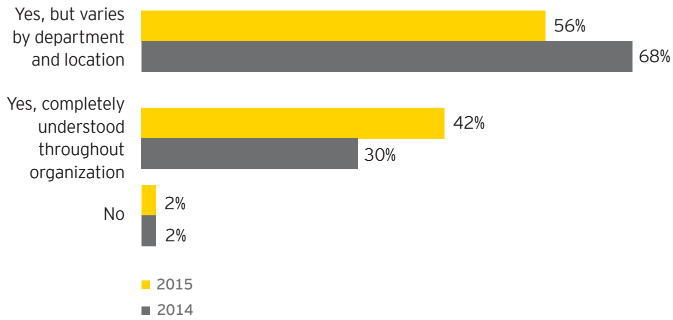
The second most important initiative (cited by more than three-quarters of the banks) is reinforcing accountability regarding risk management. The issue many are now tackling is that, traditionally, the focus of the three lines of defense approach has been on increasing the independence of the risk function, thus downplaying the role of the front office as the first line of defense. A number of banks have programs under way to address this, both by reinforcing the accountability of the front office for the risks taken and by instituting organizational changes to give the front office greater capacity to assess risk. Banks are also reviewing whether they have independent control functions for all risks. Risk functions are independent, but compliance functions, as part of their role, provide advice to the business on whether actions are consistent with the rules and, therefore, are not fully independent of the risks taken. Fifty-eight percent of respondents reported they are working to clarify and strengthen risk roles and responsibilities (see Exhibit 6).

Executives agree that well-defined and clearly articulated risk-ownership roles and responsibilities are a critical component of effective risk governance and the key first step in holding people accountable for risk management. As one executive told us, "First you have to tell them what is expected of them and then you have to hold their feet to the fire to actually do it." Reinforcing accountability has risen in importance for most firms this year; 77% versus 68% last year listed it as one of their top initiatives to strengthen risk culture.

Enforce the rules

Two key elements of risk accountability, according to many executives interviewed, are communication — that is, clearly articulating to employees that bad behavior will have consequences and that good behavior will be rewarded — and enforcement of the rules. There has been clear progress over the past year in embedding the message of accountability. Forty-two percent of respondents reported that it is clearly understood throughout their organizations that negative behavior is penalized (despite good earnings performance) and positive behavior is rewarded, an increase from only 30% last year. However, there is still work to be done. Over half (56%) say that the level of understanding of the message continues to vary by department and location (see Exhibit 7).

Exhibit 7: Is it understood throughout the organization that negative behavior is penalized and positive behavior rewarded despite earnings and performance?



On the enforcement front, firms reported a wide variety of actions under way to monitor, assess and enforce the consequences if an individual breaches controls. Ninety-four percent (up from 86% last year) say that a severe breach in conduct results in disciplinary actions in their organizations. Eighty-five percent report that a breach is escalated immediately to the risk department (an increase from 76% last year) while 69% report that a breach is handled by the desk or business-line leaders. More and more firms have introduced control systems that automatically capture and report patterns in control breaches (60% this year), and many (33%) include red-flag warning systems in which control breaches automatically affect bonuses (see Exhibit 8).

Many executives described more in-depth review procedures to assess the nature and degree of individual breaches and much tougher disciplinary practices for employees who have knowingly committed a breach. As one executive described their process, "We have learned that it is critical to act promptly on every control violation. Our special investigations unit conducts a very thorough assessment of what has happened and initiates control mitigations immediately to prevent future incidents. We look at the incident, the intent and the circumstances surrounding the breach, and then determine the proper disciplinary action, which can go from remediation to adjusted compensation to discipline and termination."

Performance management and compensation are becoming increasingly important tools to manage risk behavior. Forty-four percent of participants reported that individual behavior is reflected in career progression and compensation — an increase from 38% last year (see Exhibit 9). Executives described rigorous review processes to monitor performance. One firm, for example, has developed an assessment template that incorporates adherence to each of the firm's 10 values into the annual appraisal process used to evaluate every person in the organization around the world. Some are increasing the intensity of the performance process for individuals who could negatively impact the organization if they acted in an inappropriate way. People in these high-risk

Exhibit 8: Actions taken if an individual breaches controls

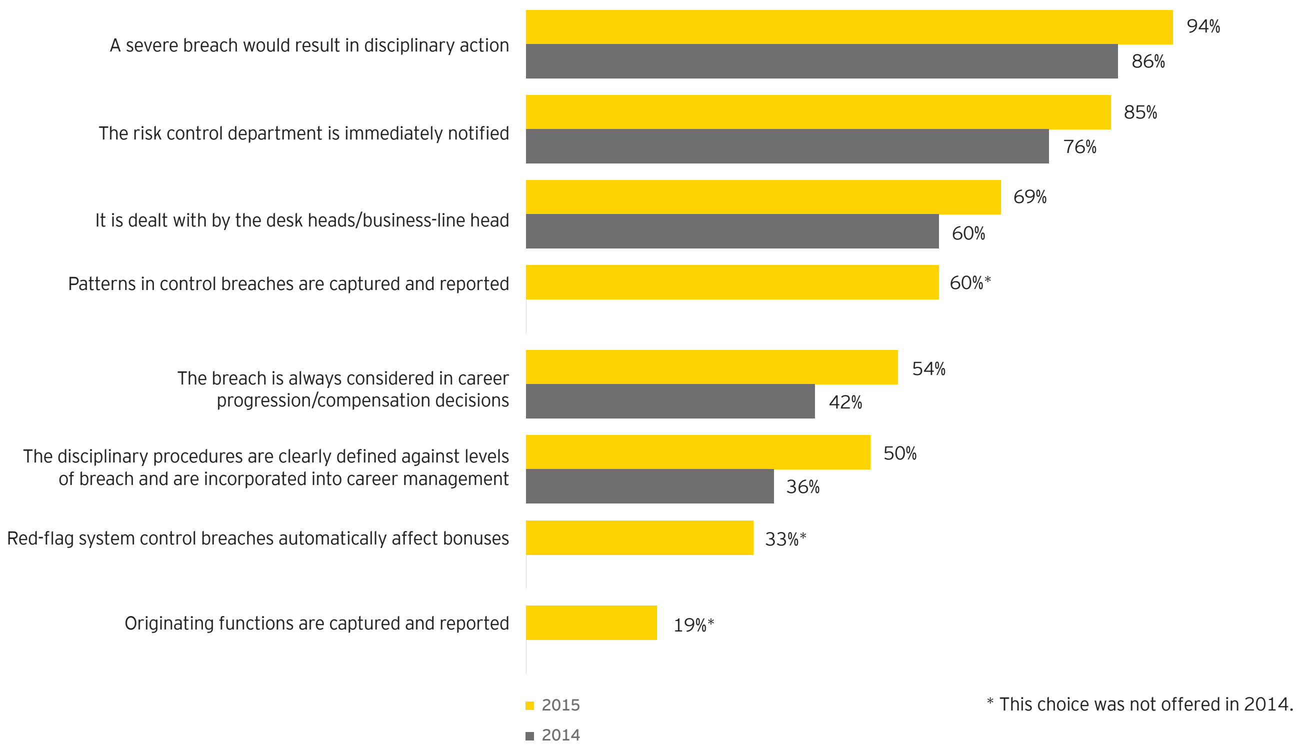
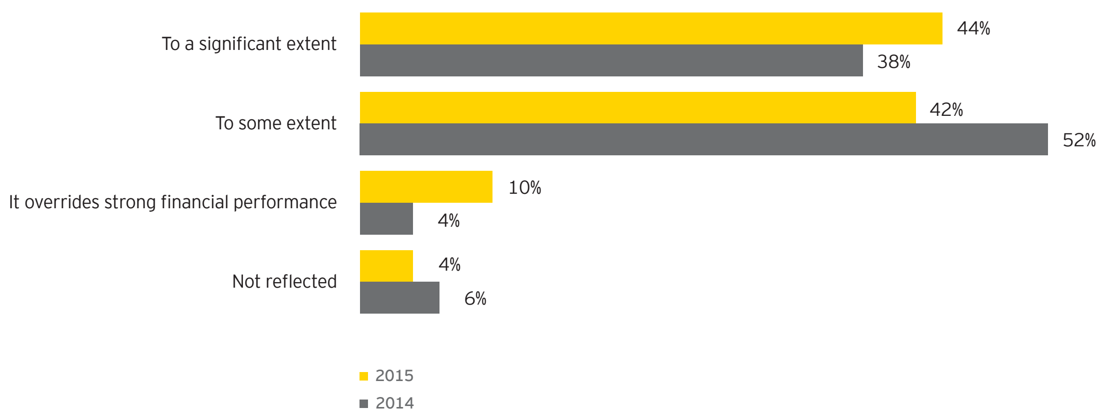


Exhibit 9: Extent to which individual behavior is reflected in career progression and compensation



categories undergo a substantial amount of increased scrutiny and are subject to deferred compensation and potential clawbacks for failure to adhere to the firm's code of conduct.

Firms recognize that creating a strong risk culture requires careful thinking about recruitment. Seventy-three percent of participants reported that risk culture is reflected to some extent in recruitment decisions. However, only 25% say that culture fit is significantly reflected in recruitment, and 2% do not consider attitudes toward risk and cultural fit at all in recruitment (see Exhibit 10).

There was much discussion around the importance of creating an open culture where people are encouraged and provided incentives to report problems. One executive explained the organization's philosophy: "One of the cornerstones of risk culture is that when you see something that's wrong, even if you caused it yourself, you have to raise it up and put it on the table. We incentivize people to raise problems, then incentivize them not to cover up. You're given almost automatic amnesty if you are implicating yourself. But if it turns out that audit or risk control uncovers that you have been trying to hide positions on anything, then you have to leave." Ninety-six percent of respondents indicated that they have initiatives in place that encourage concerns to be raised at all levels within the organization, which include assessing both individuals and business lines for their openness in raising issues (see Exhibit 11).

Exhibit 10: Extent to which risk culture is reflected in recruitment

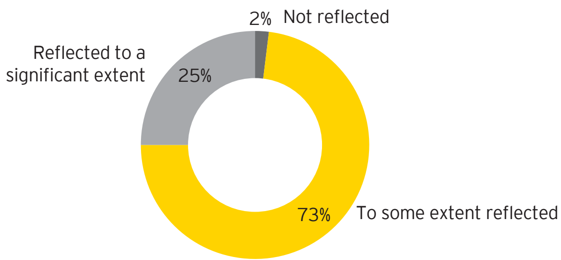
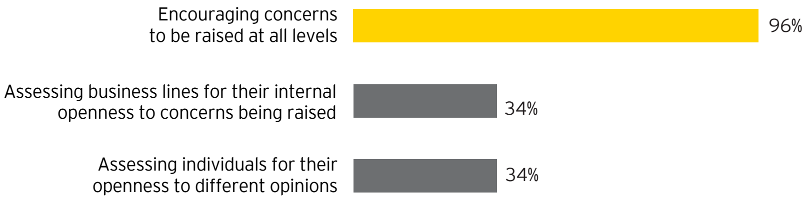


Exhibit 11: Initiatives in place to ensure an open culture

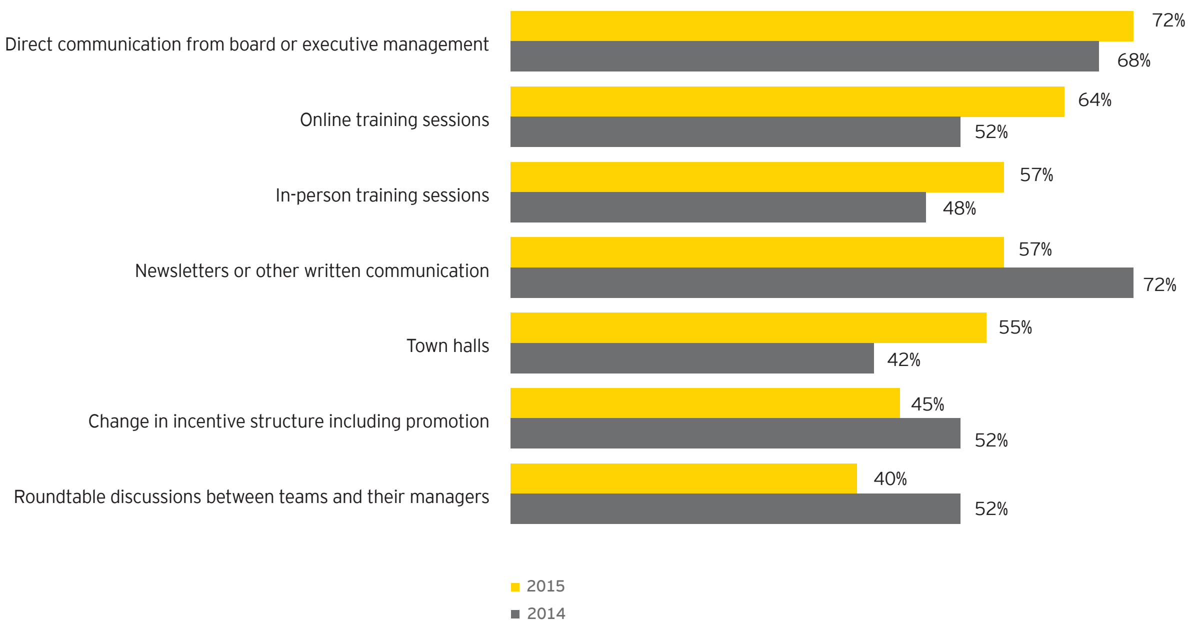


Continuously reinforce the culture

An important overall message from many of the banks is that effectively instilling risk culture is a constant and repetitive process involving a variety of channels, tools, policies and procedures. Seventy-one percent of respondents reported they are enhancing communications and training programs to raise awareness of risk values and expectations (see Exhibit 6), and as can be seen in Exhibit 12, firms are deploying a variety of methods, from direct communiques from the CEO and board to newsletters, town halls, roundtable discussions and new staff induction programs, in order to cascade the risk culture throughout their organizations. One firm recently reaffirmed its eight key values and its code of ethics through a global multimedia campaign using the firm's internal social media and television network.

Training programs are playing a very important role in raising awareness and understanding of the firm's values and rules of conduct, and many interviewees described extensive firmwide programs that are mandated and monitored for every person in the organization. As one executive described the evolution of the firm's compliance training process, "Four years ago, people were told to do training programs, but there was no ability to track and follow up if somebody didn't do it. Last year, all of our training programs became digital and compulsory. Everyone must complete each module of the program, and they are acutely aware there will be ramifications for not doing the training."

Exhibit 12: Methods to ensure that risk culture messages are cascading effectively throughout the organization



Constantly review, assess and monitor progress

The industry has not yet settled on an effective way to monitor and measure risk culture throughout the organization. One bank executive referred to measurement of risk culture as "a bit of a Holy Grail." Indeed, less than half (47%) of the respondents say they have an agreed-upon framework to assess risk culture (see Exhibit 13). Firms that are monitoring culture are typically using a combination of quantitative and qualitative metrics or, as one executive explained, "For us, measuring culture is a bit of a triangulation of three or four different sources of information – some quantitative, some qualitative and some based on the judgment of our senior management."

Exhibit 13: Is there an agreed-upon framework by which risk culture is regularly assessed?

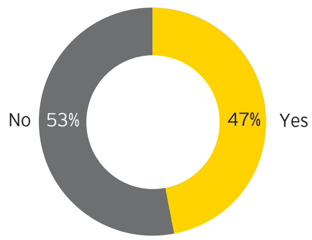
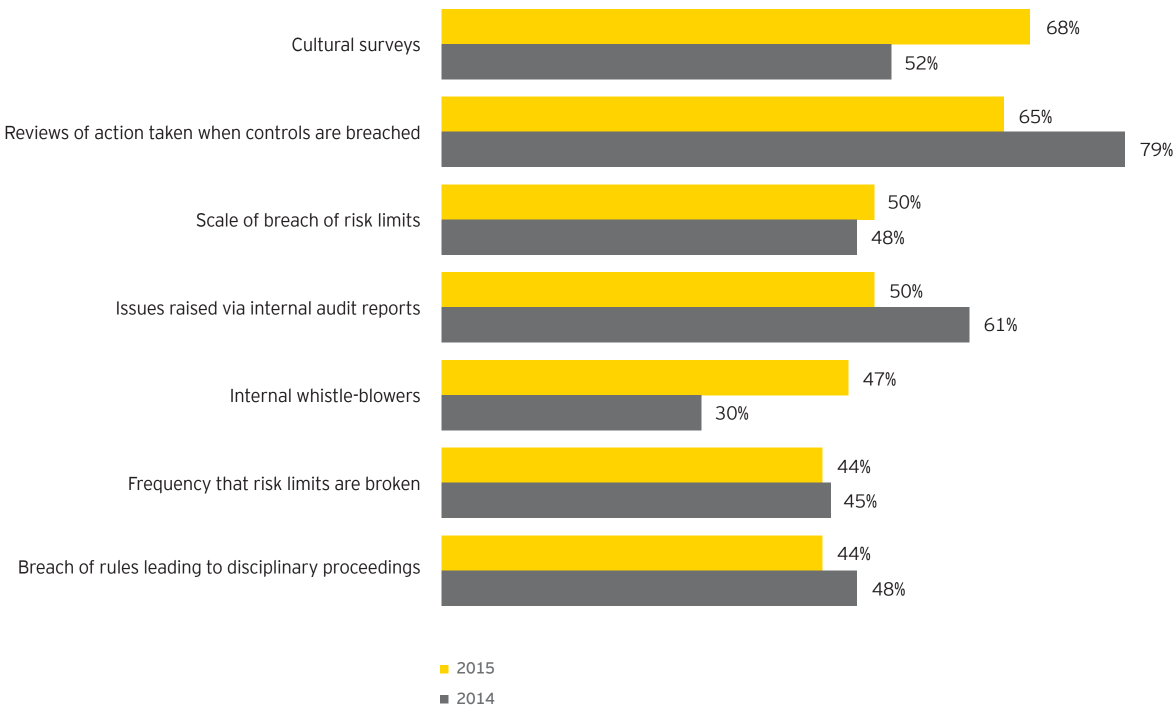


Exhibit 14 illustrates some of the key monitoring tools that firms are adopting to measure the risk culture. Assessing the frequency, scale and causes of breaches to risk limits and how they are reported and handled are all listed as primary measurements. Sixty-five percent review the actions taken when controls are breached, and 50% review the issues raised via internal audit reports, including the manner in which they are handled and the pre-existing awareness of the problems, to determine if management was surprised by the findings or was already addressing the issues.

Surveys have become increasingly more important assessment tools for many firms, with 68% of respondents (an increase from 52% last year) reporting that they utilize cultural surveys to monitor the culture. Several described specific assessments of the risk culture conducted by third parties to identify gaps in the culture and establish benchmarks to measure against as they go forward. Many executives agree that the frequency of surveys is critical to measuring progress, and many firms have incorporated risk-culture-specific questions into their annual employee surveys.

And, per our earlier discussion on creating an open culture, an increasing number of firms (47%, up significantly from 30% last year) track the frequency and treatment both of self-reported control and risk problems and whistle-blowing incidents.

Exhibit 14: Methods to monitor adoption of risk culture

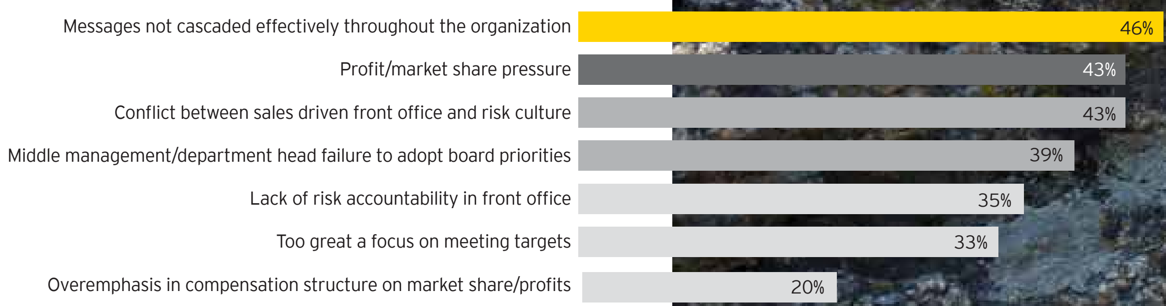


Causes of a breakdown in risk culture

Executives agree that institutionalizing a strong risk culture that creates a tangible sense of risk ownership from the top ranks of the organization down to the front-line staff requires fundamental organizational changes that, in turn, require a long-term commitment and investment.

To be successful, these changes must be driven from the top of the firm, but with buy-in down the line from businesses. They require a considerable amount of time and commitment on the part of the board, CEO, CRO and the entire senior management team to determine, communicate and instill the firm's values, culture and code of conduct. "Tone from the top" was repeatedly cited as critical to strengthening and sustaining a strong risk culture. Forty-six percent of respondents believe that the failure to effectively cascade messages from the board and senior team throughout the organization is one of the primary causes of a breakdown in risk-culture behavior (see Exhibit 15). As one executive told us, "Transforming hearts and minds and, ultimately, behavior, requires relentless messaging from the top of the organization."

Exhibit 15: Top causes of a breakdown in risk culture behavior



Aligning the sales-driven front-office culture with the broader firmwide culture has been repeatedly cited over the past several years as a top challenge to strengthening the risk culture, and the absence of such alignment is seen by 43% of firms as a cause of breakdown in risk culture. Lack of a sense of accountability in the front office was seen as a cause of risk culture deviating from board expectations by over one-third of respondents.

Bottom line: the key ingredients for creating a strong risk culture must include direction and "relentless" communication from the top of the organization; a strong risk appetite that is embedded into business strategy and planning; clearly defined roles, responsibilities and accountability; and strong consequences for misbehavior through performance management, compensation and disciplinary actions. For many firms, making risk everyone's business represents a significant shift in mindset, policies, systems and processes.

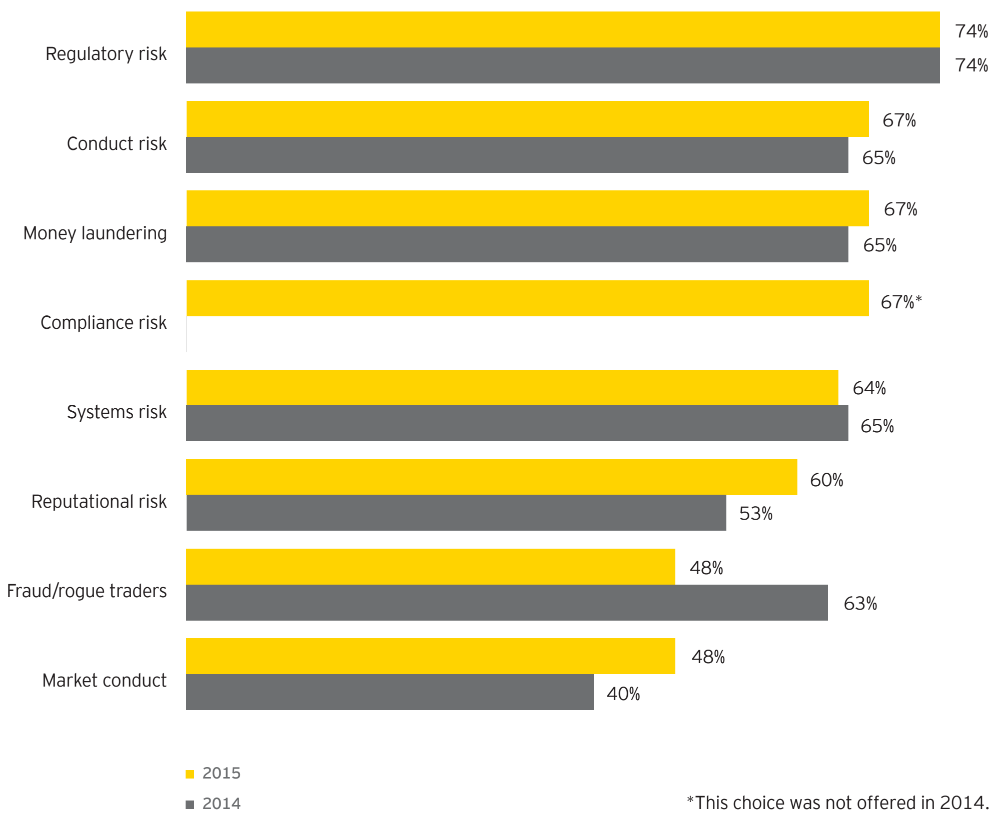
"It doesn't matter if you are managing a canteen, a branch or a business line — every manager, regardless of level, must have complete and full responsibility to manage risk in his or her area. It's the key to risk culture."

Non-financial risks

Conduct risk is a top focus for most banks

Almost all banks have increased their focus on operational risk, and many are now looking at it in a more granular way — by sub-risk types such as conduct, compliance, reputation, money laundering and systems. Non-financial risks like conduct are now a top issue because of the range of adverse events that have come to light and the huge cost to the industry from a variety of conduct and compliance events with sizable financial and reputational costs.

Exhibit 16: Non-financial risk areas of increased focus

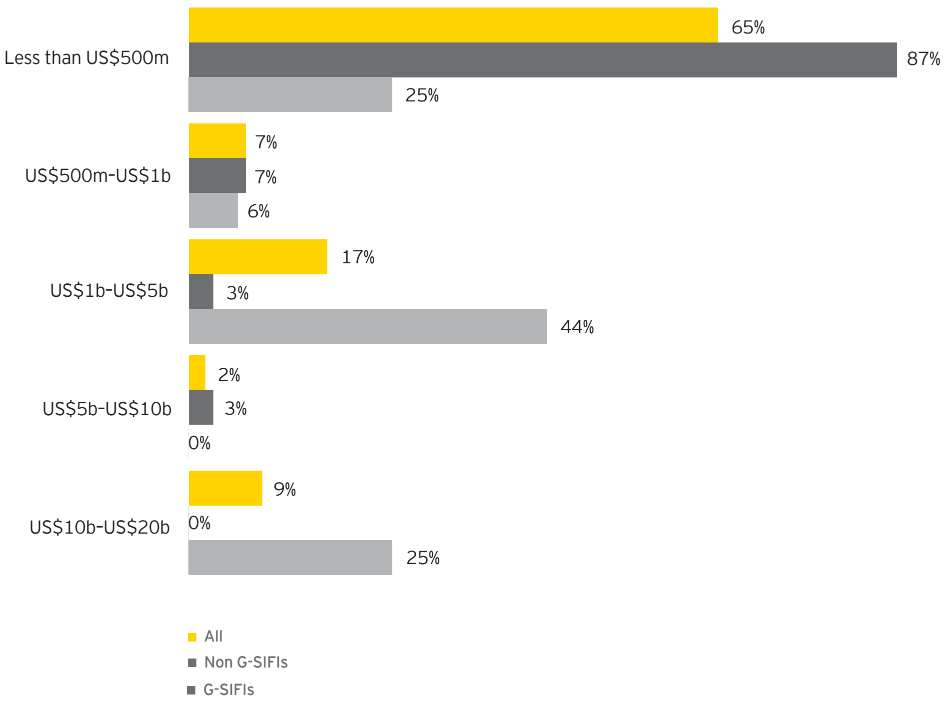


*This choice was not offered in 2014.

Eighty-nine percent of this year's respondents reported an increase in the focus on non-financial risks. Seventy-four percent of respondents list regulatory risk as their top area of focus under the non-financial risk category, followed by conduct, money laundering and compliance risk (all at 67%), systems risk (64%) and reputational risk at 60%, up from 53% last year (see Exhibit 16).

Losses from non-financial risks (inclusive of regulatory fines and penalties) have been high for the G-SIFIs in comparison with other banks. Only 25% of the G-SIFIs reported losses of less than US$500 million, compared with 87% of non-G-SIFIs. Forty-four percent of G-SIFIs reported losses between US$1 billion and US$5 billion, and 25% reported losses of up to US$20 billion (see Exhibit 17). Eighty

Exhibit 17: Total non-financial risk losses over the past three years



percent of G-SIFIs reported that weak oversight and controls had contributed to the losses, compared with only 56% of non-G-SIFIs (see Exhibit 18). And, while 91% of the overall sample (up from 84% last year) said their losses were within the capital held for non-financial losses, only 24% said that there was a scenario assessment in place for the type of risk leading to the loss prior to the event, and only 9% (down from 14% last year) had noticed that the risk was rising prior to the event (see Exhibit 19).

Firms are proceeding with initiatives to strengthen non-financial risk management

Firms reported several key activities focused on improving risk assessment and identification processes. Seventy-two percent have strengthened their loss-reporting procedures and forensic investigative processes to analyze why and how loss events occurred and to identify weaknesses — whether fundamental or incremental — in individual processes that require adjustments to controls. However, there was considerable emphasis on forward-looking analysis rather than after-the-fact assessment. This was a key mantra for the executives interviewed, and

Exhibit 18: Internal factors that contributed to these losses

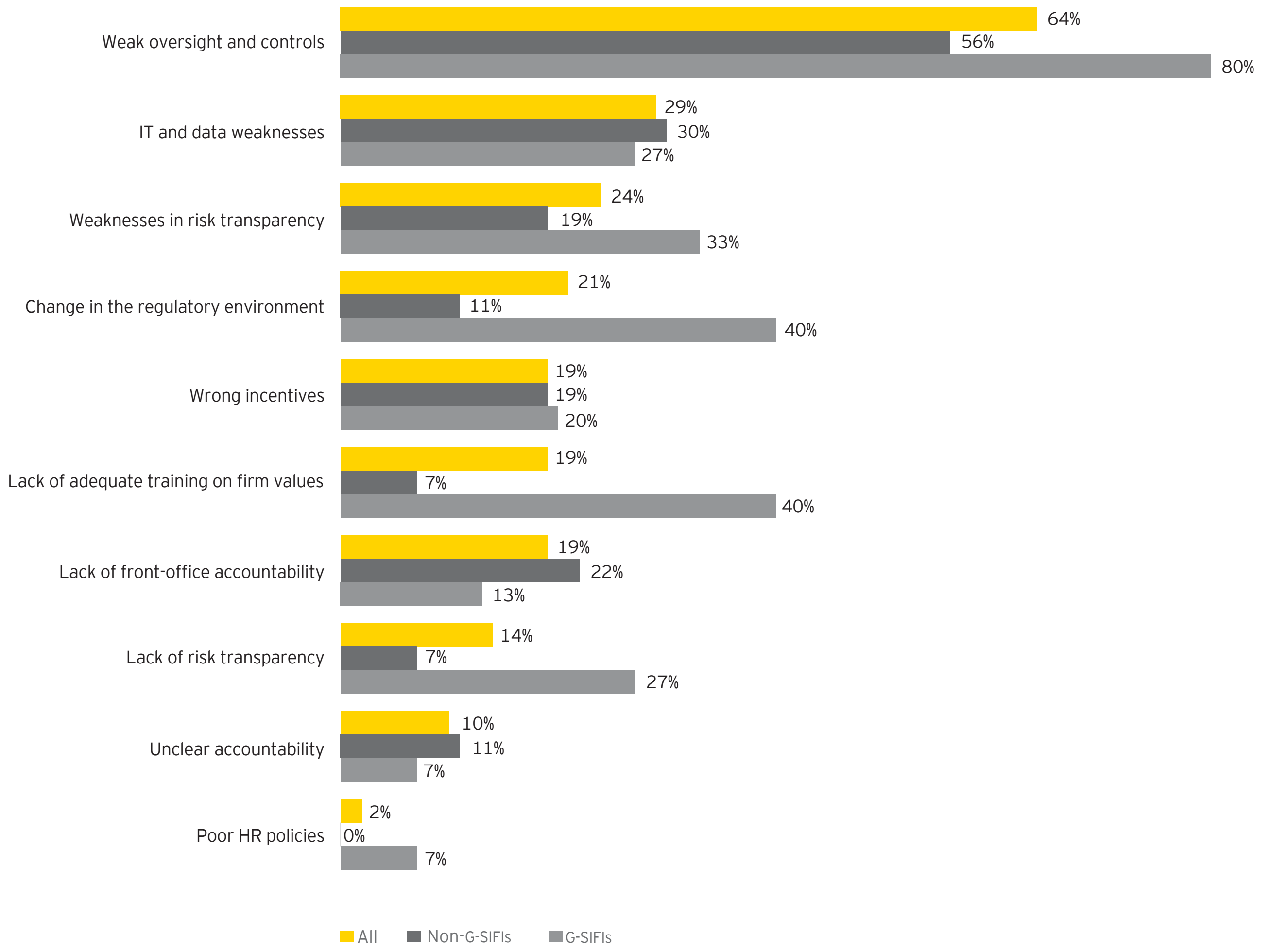


Exhibit 19: The vast majority report losses were within the capital held for risk

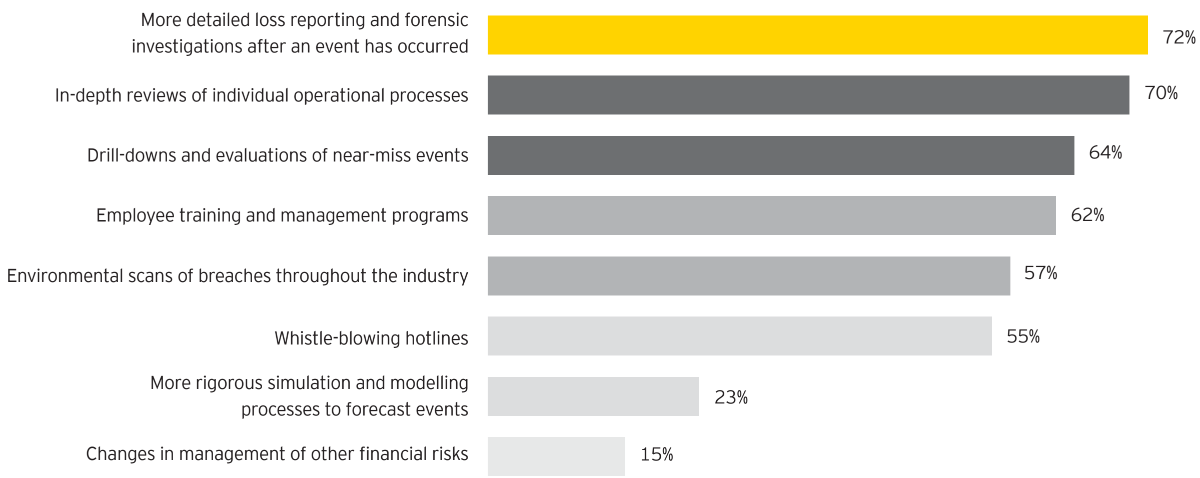
many described initiatives to prevent losses before they occur. Seventy percent of respondents are conducting in-depth reviews of individual operational processes to, as one executive said, "Map each and every step for every process so that we can track and pinpoint where things can go wrong and flag them more quickly before they escalate into full-blown events." Others described simulation and modelling processes to better forecast and prevent events; environmental scans to understand the nature of breaches in the industry; deep drill-downs and evaluations of near-miss events to tighten controls; whistle-blowing hotlines; and employee training and management programs to improve accountability and enhance performance (see Exhibit 20).

being formalized and enforced for the front-office teams through clarity on accountabilities, supported by performance management, compensation and disciplinary actions for misbehavior.

Make conduct-risk management more effective

Given the heightened regulatory and public attention to misconduct in the industry, many firms reported increased attention to conduct risk. When asked what specific areas of conduct risk they were most concerned about going forward, product mis-selling (70%) and money laundering (52%) ranked

Exhibit 20: Actions under way to prevent future non-financial risk losses



The importance of assigning and monitoring accountability has increasingly emerged over the past year as a key factor in non-financial risk management. Ninety-four percent of this year's respondents (up sharply from 79% last year) reported that they now hold the front office — desk heads and business-unit heads — accountable for a wider view of risk that includes non-financial risks and conduct risk (see Exhibit 21). As discussed in the chapter on culture, responsibilities for managing risk are

highest for all banks. G-SIFIs cited greater focus across multiple additional areas, including market abuse, unauthorized trading, sanctions and financial advice (see Exhibit 22). Because of these concerns, many firms have undertaken special initiatives aimed specifically at strengthening conduct risk processes and controls. As one executive described their activities, "We are treating conduct risk as one of our principal risk types, and we have a huge amount of activity going on with conduct

Exhibit 21: Front office holds accountability for non-financial risk

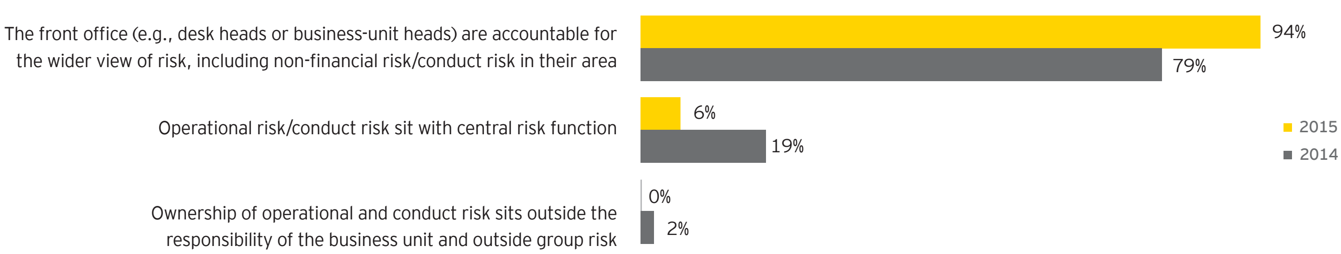
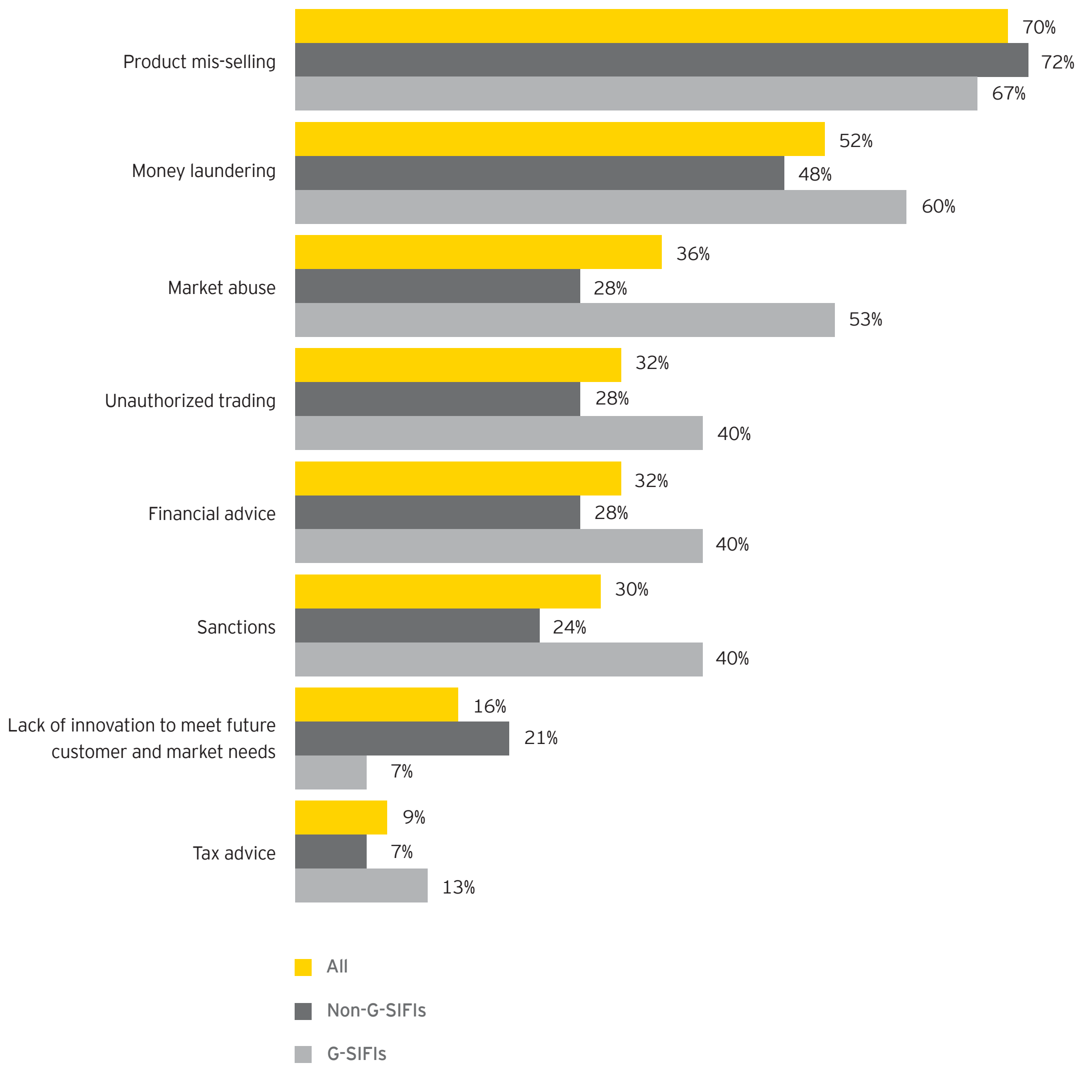


Exhibit 22: Highest conduct risks going forward



risk at the moment — defining the governance structure, strengthening policies and procedures, challenging and adjusting the metrics. It's a significant investment of time and resources."

On a fundamental level, many are working to eliminate or reduce the intrinsic risks inherent in their current business models. As can be seen in Exhibit 23, firms are dropping certain products and transactions and exiting markets and countries to reduce areas of risk. Other actions to reduce inherent risk are reducing the complexity of products and changing customer-facing activities. Additional modifications are focused on altering incentives for staff by changing sales incentives and adjusting revenue and sales targets.

Firms also described a range of initiatives to strengthen conduct-risk management. Many are strengthening risk assessment and measurement of conduct risk, increasing accountability for conduct risks in the business lines, strengthening second line of defense monitoring and testing, and embedding conduct risk into the business model, strategy analysis and HR processes. Products and customers are both heightened areas of attention for study participants. Sixty-two percent listed an increased focus on new products as a top initiative to strengthen conduct risk management, and 38% reported an increased focus on new customers (see Exhibit 24).

Exhibit 23: Actions under way to reduce intrinsic conduct risks

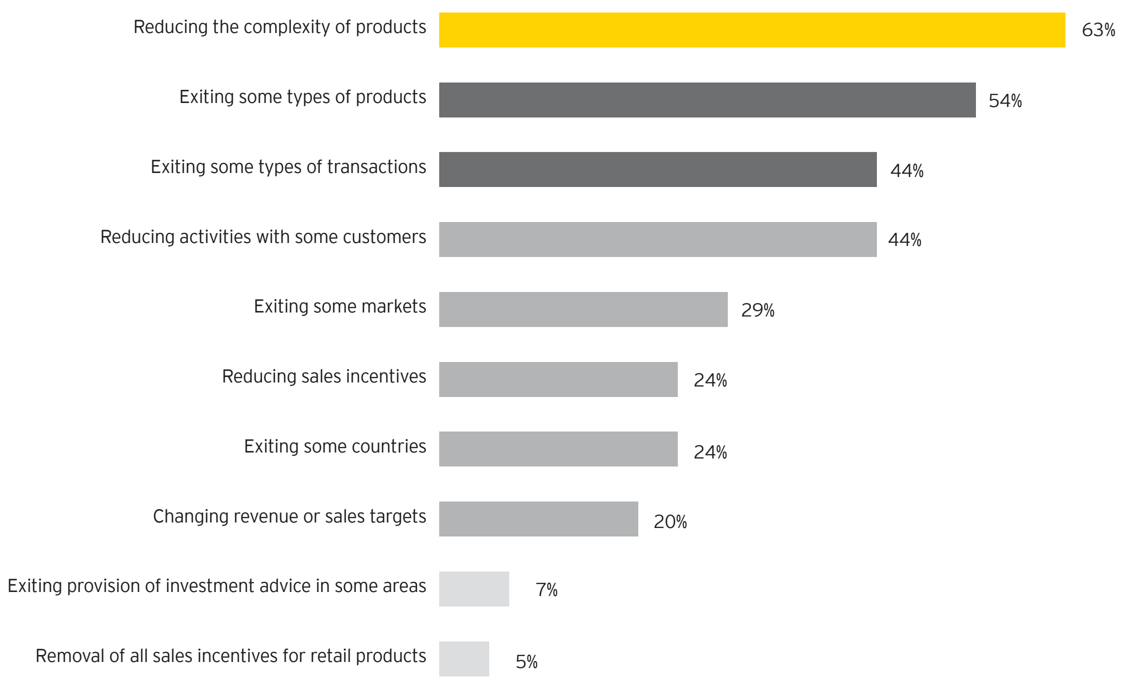
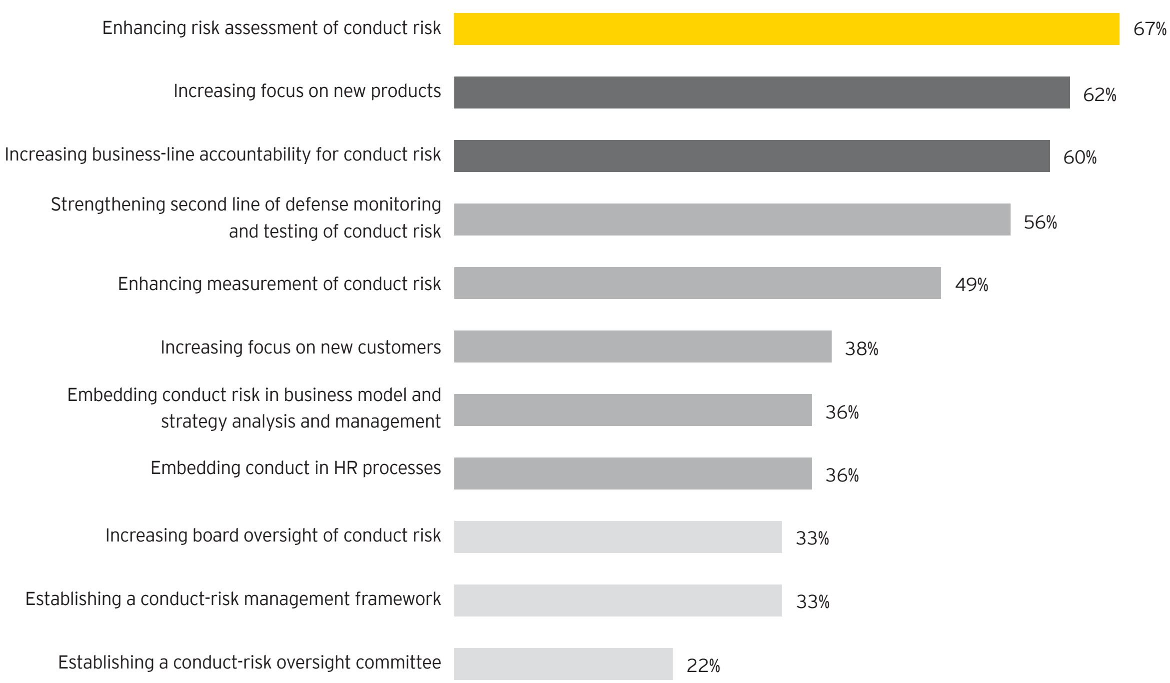


Exhibit 24: Initiatives to strengthen conduct risk management



On the product development front, more than half of the respondents have introduced new product approval processes (57%) and greater oversight of the committee responsible for new products (51%). Over 40% have strengthened escalation processes for new products, and a few firms (14%) have established new cross-functional senior committees to monitor new product development (see Exhibit 25).

Treating customers fairly was an important topic of discussion for many of our interviewees. The broad incidence of product mis-selling that has continued to plague the industry has caused firms to assess and strengthen customer-facing activities. Among the initiatives cited were new rules for customer management, improved analysis and identification of appropriate customer targets for individual products, internal training programs, stronger links to customer management in performance evaluations and compensation, and new escalation processes for misconduct (see Exhibit 26).

Exhibit 25: Changes to the product development process

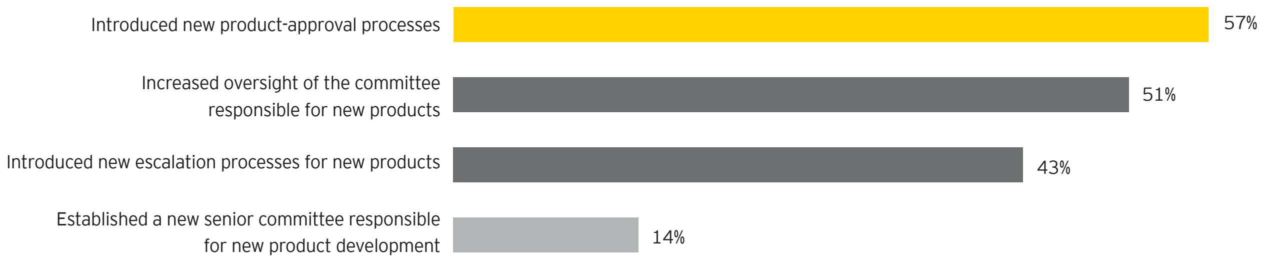
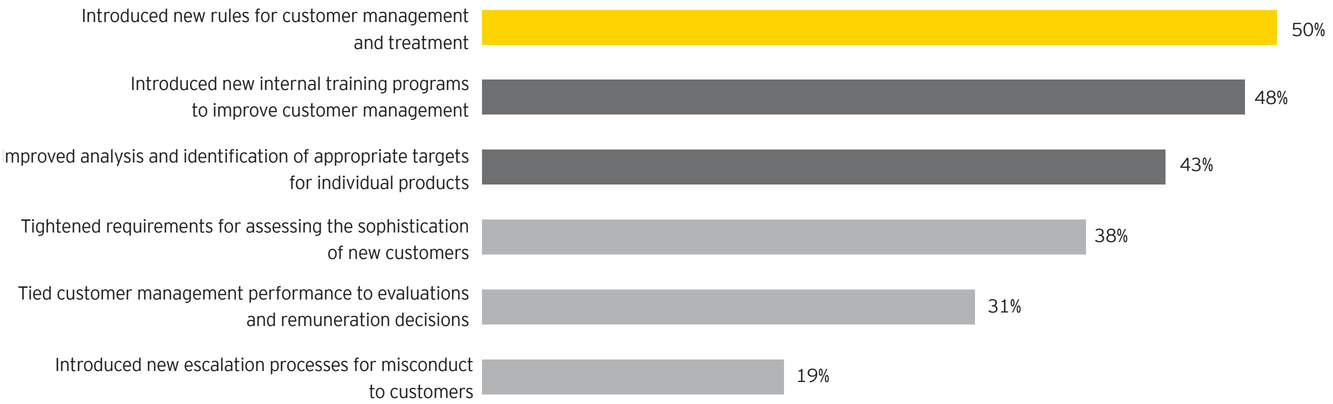


Exhibit 26: Changes to customer-facing activities



Monitoring, measurement and enforcement are key components of managing conduct risk

Many of the executives interviewed discussed the challenges of monitoring conduct risk. As one executive explained, "For us it's still a bit too anecdotal. Businesses and functions self-identify key conduct challenges that they have, and we talk about ways to mitigate those, but it's obviously not perfect. Establishing forward-looking metrics is our ultimate goal and what we are working on now." As can be seen in Exhibit 27, respondents listed a number of initiatives to monitor and measure conduct risk. Assessments — both self-assessments from the businesses and risk-and-control assessments from the risk management and compliance functions — are being put in place, as are new processes to improve collection of data on past events and analysis of intrinsic risks.

A powerful message from the survey is the extent to which banks are moving away from a traditional legal/control mindset to address non-financial risks to a more risk-focused approach where in addition to emphasis on controls there is also assessment of the amount of risk in the activity. While the rules and controls continue to be important, the focus is increasingly on what drives intrinsic risks and whether those risks are growing. Over half of the participants (54%) are working to develop more forward-focused risk assessments for non-financial risks and are enhancing stress and scenario analysis and modeling of stand-alone conduct risks. Interestingly, automation to monitor and escalate control breaches is not yet widely used in the firms studied, with half of the respondents reporting that their firms do not have a system in place to automatically flag breaches and link them to bonuses (see Exhibit 28).

Exhibit 27: Initiatives to monitor and measure conduct risk

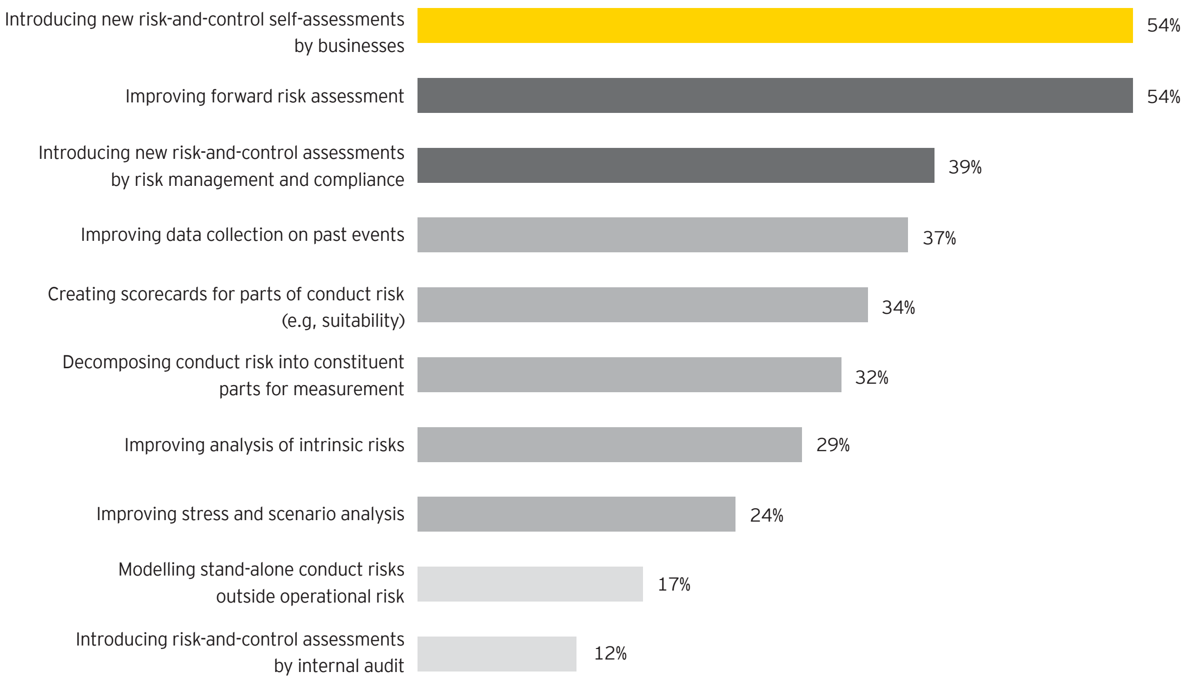
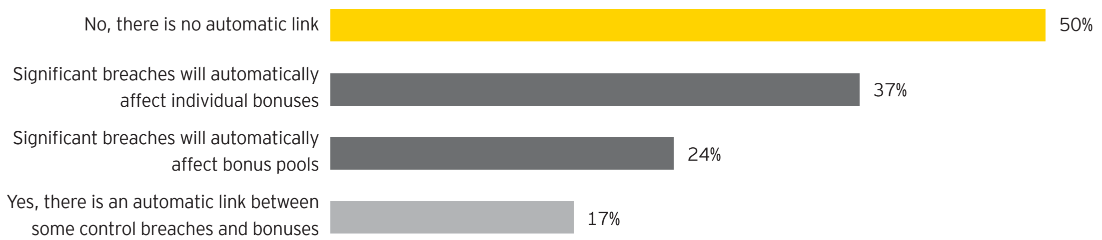


Exhibit 28: Use of automation to link control breaches to bonuses

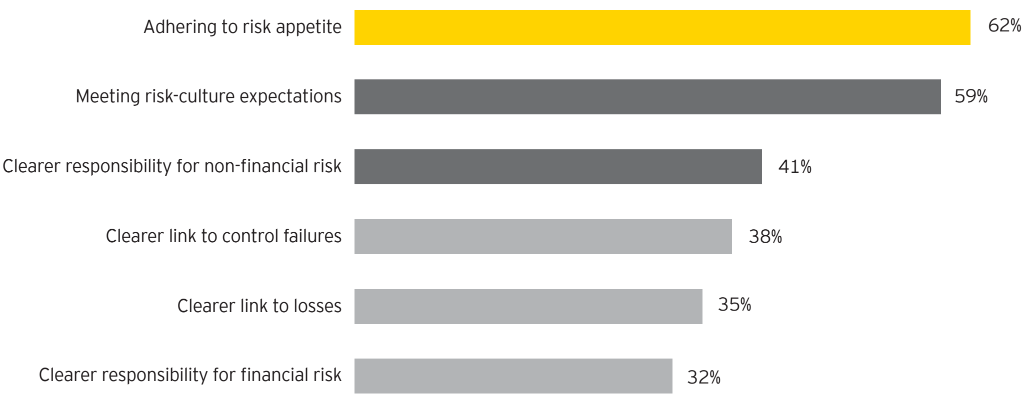


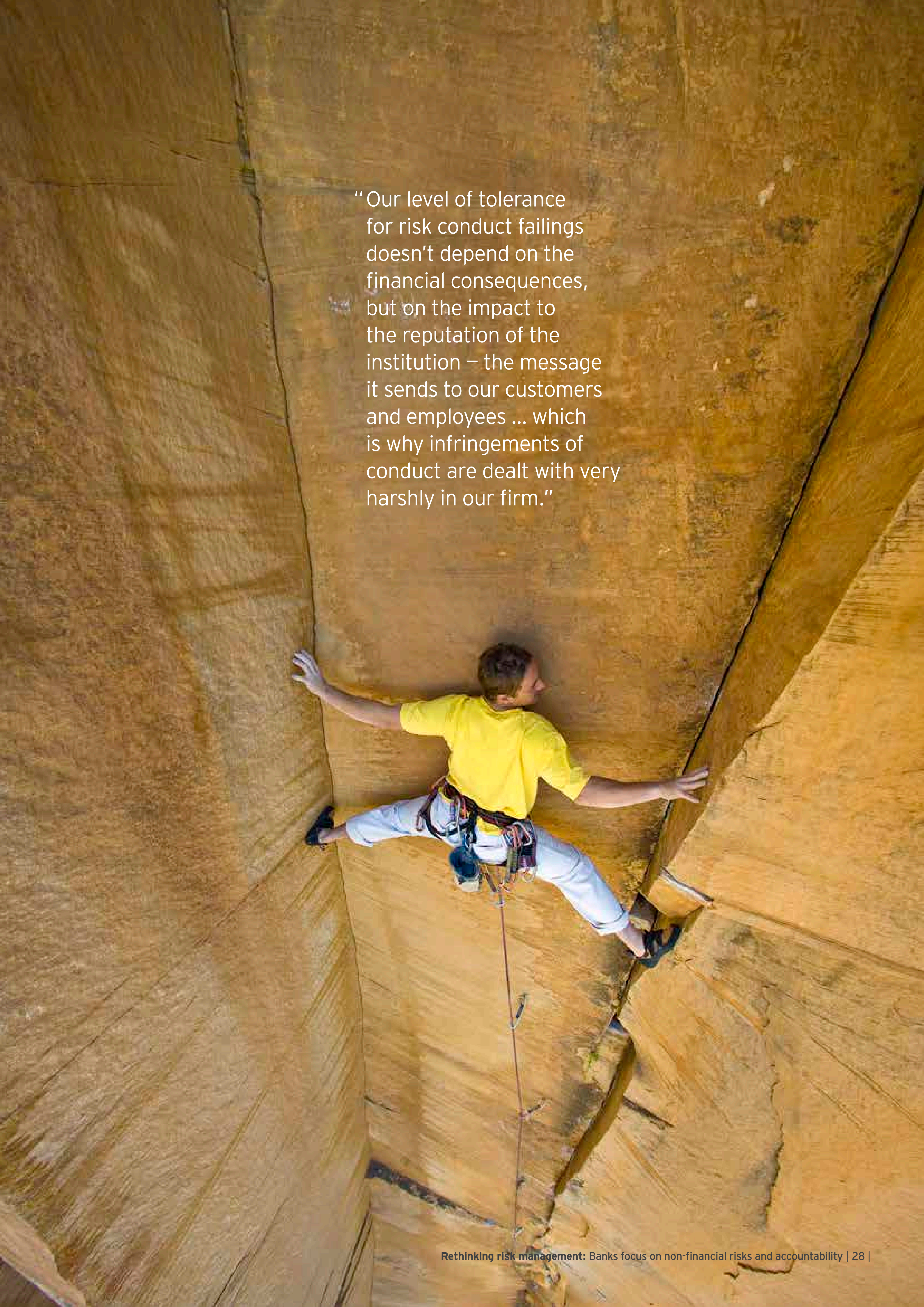
As discussed in the culture chapter, firms are tying their performance metrics and compensation decisions more closely to behavior-related risk culture and risk controls. More than three-quarters of the respondents reported that performance evaluations for either the business-unit heads, their direct reports or both have been tightened to include risk conduct, and close to one-third (30%) of participating firms reported they are linking risk controls to performance evaluations across all professional staff. Evaluation criteria and compensation decisions are based on adherence to risk appetite and risk culture and are meant to establish clearer levels of responsibility for managing non-financial risks, control failures and losses (see Exhibits 29 and 30).

Several executives discussed the challenges of meeting what one called "the new frontier" of regulatory requirements. According to one interviewee, "Unlike liquidity rules and capital ratios, conduct risk is much trickier and more difficult to manage. For example, treating customers fairly, how do you judge that? Is it 100% of what we are trying to achieve? Is 80% acceptable? Is 40% a failure mark? What metrics and processes do you need to have in place to measure how well you are doing?" Despite these challenges, however, many firms across the industry are strengthening the customer focus in the business to address the reputational damage from the various mis-selling cases.

Exhibit 29: Firms report establishing a closer link to risk culture and risk controls in performance metrics

Exhibit 30: Compensation now linked to adherence to risk appetite, culture and conduct





"Our level of tolerance for risk conduct failings doesn't depend on the financial consequences, but on the impact to the reputation of the institution — the message it sends to our customers and employees … which is why infringements of conduct are dealt with very harshly in our firm."

Risk appetite

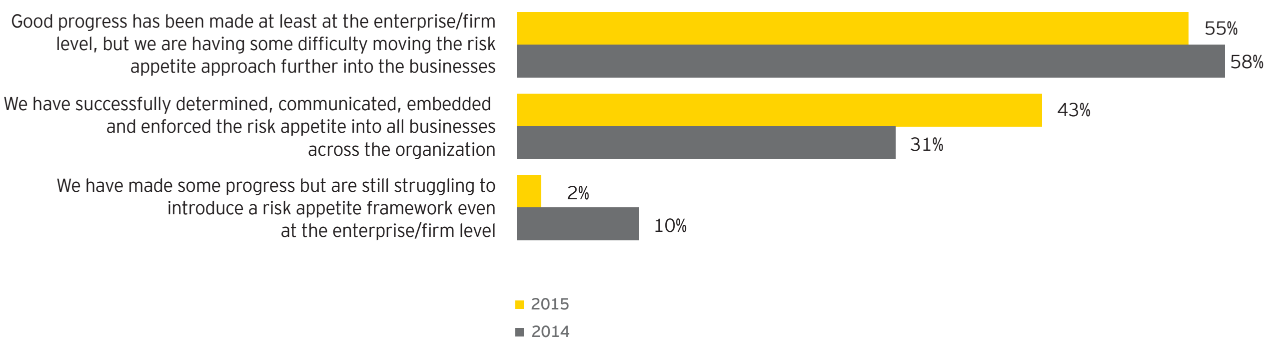
Embedding risk appetite in the businesses remains the top challenge

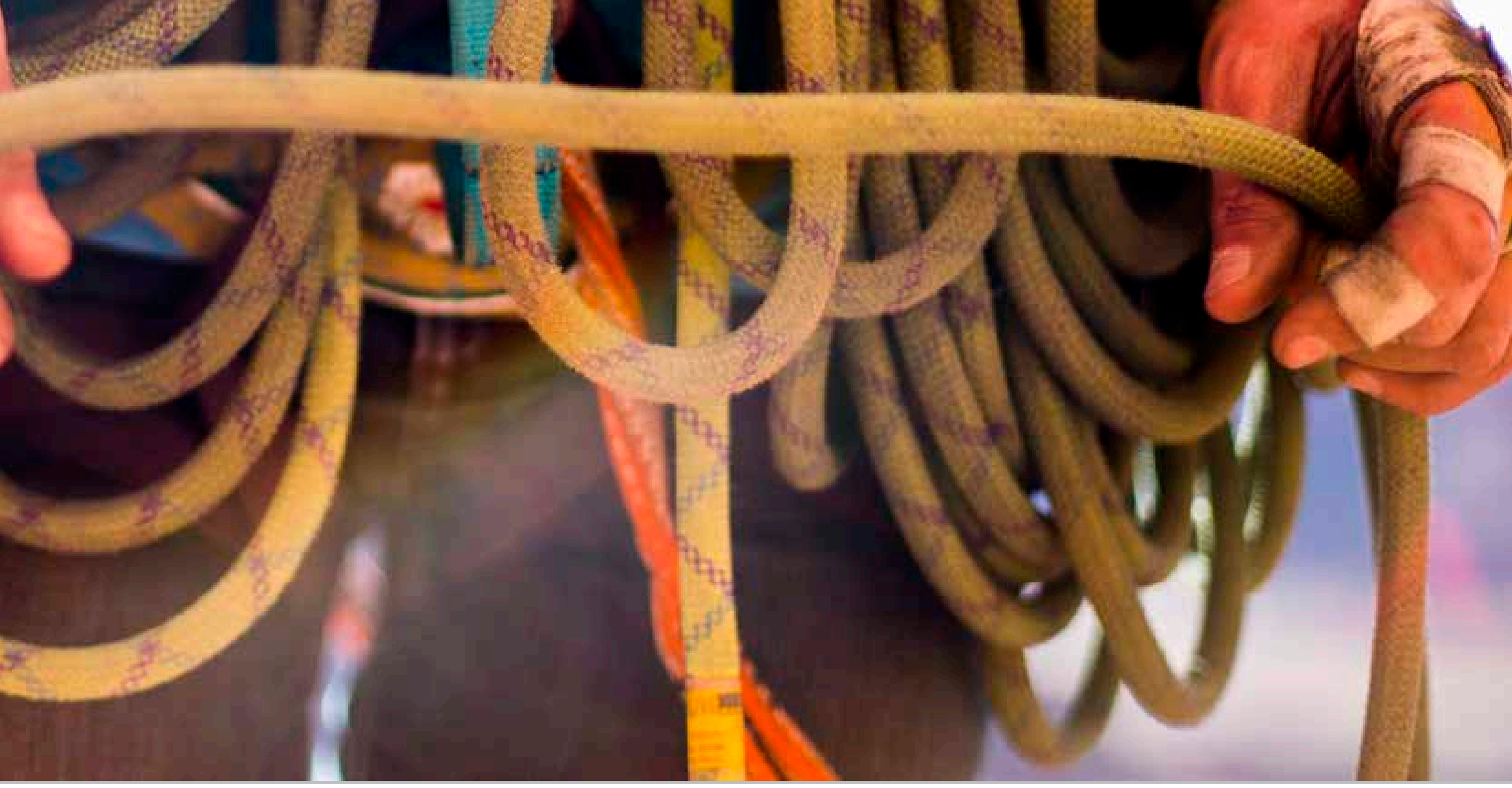
Risk appetite remains an ongoing area of development for many banks. Despite the fact that risk appetite has been a key area of focus for both boards and CROs over the past several years, many firms are still finding it difficult to translate the firmwide risk appetite strategy into the day-to-day planning and operations of their businesses. Fifty-five percent of respondents say that, while good progress has been made at the enterprise level, they continue to have difficulty moving the risk appetite approach further into the businesses (see Exhibit 31).

Survey results and discussions with executives point to four key factors critical to successfully cascading and embedding the firmwide risk appetite:

1. Apply a top-down, bottom-up approach
2. Link risk appetite to day-to-day business planning and individual business decisions
3. Clarify metrics
4. Establish clear reporting and accountability processes

Exhibit 31: Firms continue to work at integrating the risk appetite approach into the business units





Apply a top-down, bottom-up approach

The majority of the executives interviewed agree that successful execution of a firmwide risk appetite must be achieved by a collaborative, top-down, bottom-up approach. While the board ultimately approves the risk appetite, its development must involve the CEO, CRO and CFO in discussion with the business leaders. Executives say that, in order to work, the risk appetite must be practical, measurable and capable of being executed — and understood at the front-office level. As one executive told us, "The most successful aspect of our risk appetite is that the businesses get it, see the value and use it."

Link risk appetite to business strategy and planning

The starting point for embedding risk appetite is linking it with strategy, and here the industry has made real progress. Seventy percent of participants reported "significant linkage" (an increase from 63% last year) of risk appetite to business planning (see Exhibit 32). However, while progress is being made, there is still work to be done to truly manage and monitor the risk appetite linkage to day-to-day decisions. Less than half of this year's respondents (43%, an increase from 35% last year) consider individual business decisions to be "largely" tested against risk appetite (see Exhibit 33).

Clarify the metrics

Consensus is emerging on the key quantitative metrics to set and monitor risk appetite at the group level. Banks are coalescing around certain key metrics in the risk appetite statement although there are differences between the G-SIFIs and other banks. Liquidity measures are almost universal for the G-SIFIs (94%) but less widespread (79%) for other banks. Non-G-SIFIs are more dependent on using limits in the core statement (61% of respondents against only 25%) than

Exhibit 32: A significant majority of banks report significant linkage of risk appetite to business planning

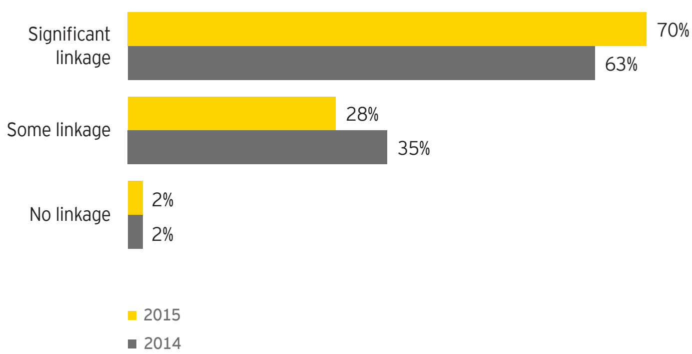
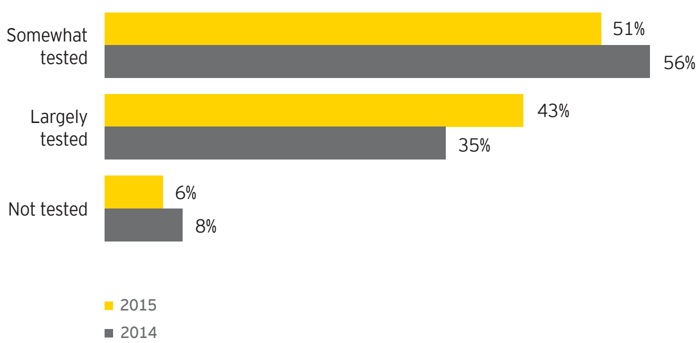
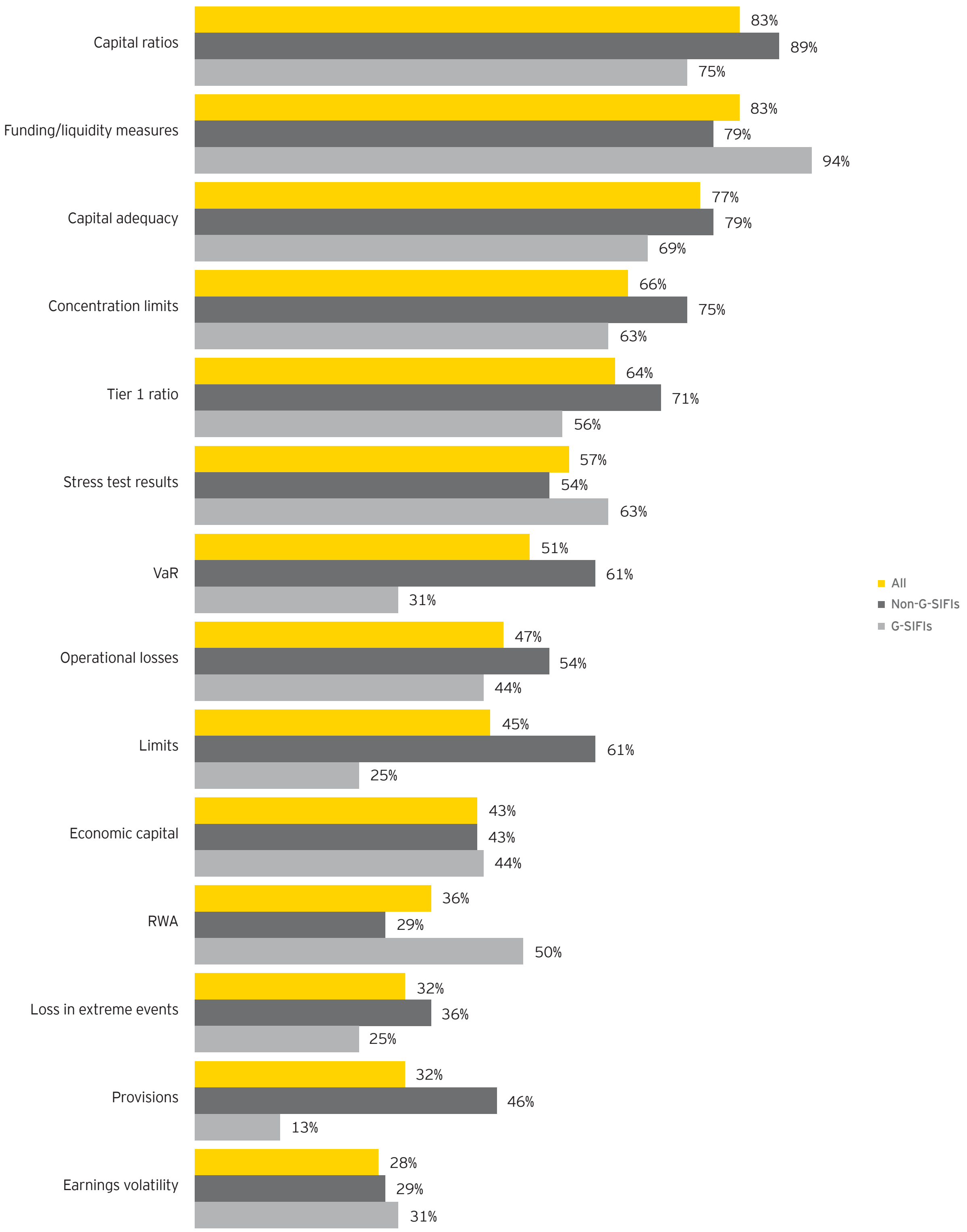


Exhibit 33: 43% report that individual business decisions are "largely tested" against risk appetite



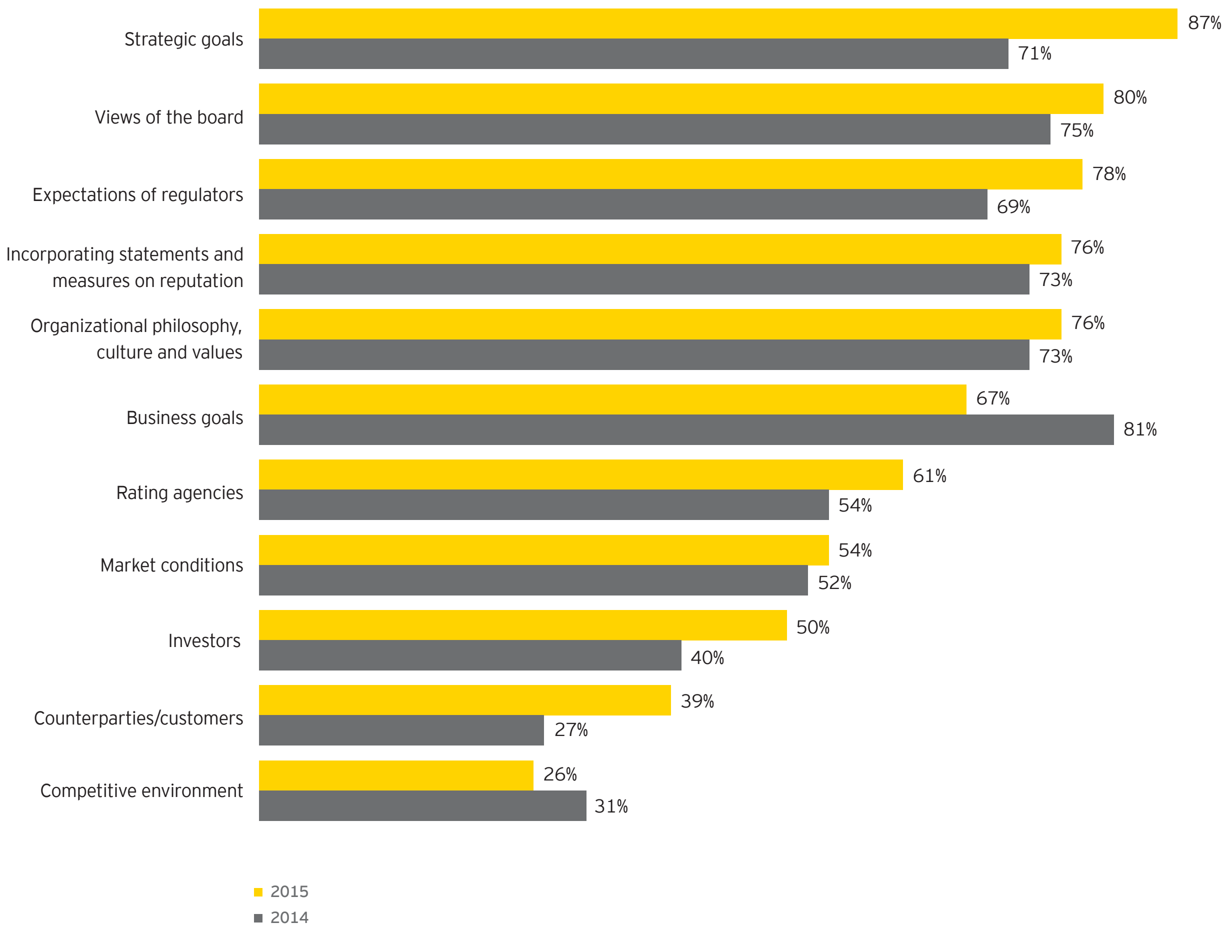
the G-SIFIs. The G-SIFIs use the limits to deliver the appetite expressed in other ways. For example, nearly two-thirds of G-SIFIs use stress test results as a forward loss metric to manage limits and decisions on strategy. Only half of the non-G-SIFIs use stress test results. With the pressure on ROE for G-SIFIs particularly, half of G-SIFIs have risk-weighted assets (RWA) as a central metric versus 29% for other banks. Most banks have some capital metric in the central statement (see Exhibit 34).

Exhibit 34: Primary metrics in setting risk appetite at the group level



On the qualitative side, firms are striving to balance internally driven goals — strategic and reputational goals, board viewpoints and organizational philosophy, culture and value parameters — with expectations of external stakeholders, including regulators, rating agencies, investors, counterparties and customers (see Exhibit 35).

Exhibit 35: Qualitative issues affecting setting of risk appetite



Establish clear reporting and accountability processes

Tracking, reporting and holding people accountable were all cited as critical to embedding and managing risk appetite. Fifty-seven percent of respondents reported significant progress in their ability to track and enforce adherence to risk appetite over the past 12 months (see Exhibit 36). As discussed in our chapter on culture, many firms are working to tie adherence to risk appetite to the performance review and compensation process, which many feel is the only way to "give it teeth" and effect change.

Virtually all of our respondents of the past two years are regularly monitoring adherence to risk appetite in their organizations. While 66% report annual formal reviews, a growing number of firms, particularly G-SIFIs, are conducting more frequent reviews on a quarterly, monthly and, according to some executives interviewed, "a day-to-day, transaction-by-transaction basis" (see Exhibit 37).

Risk appetite approaches for non-financial risks are on the rise

Not surprisingly, given the rise in regulatory scrutiny of the management of non-financial risks, firms are broadening their traditional risk appetite approach to include operational risks. Eighty-three percent of participants indicated that they have begun to create a risk appetite approach for non-financial risks, including conduct and compliance, and while approaches vary, the majority (74%) use a tailored approach for different non-financial risk types within the operational risk framework (see Exhibits 38 & 39).

Effectively cascading the risk appetite through the operational levels of the organization remains the top challenge to implementing risk appetite. Executives agree that embedding risk appetite requires attention to all of the activities discussed throughout this report: shifting the cultural mindset around risk; strengthening governance structure roles and responsibilities; adjusting performance requirements and compensation; and upgrading systems and processes to test, track and assess progress. For most, the process of development and implementation is a long-term effort, and sustaining it over time is an ongoing journey.

Exhibit 36: Over half report significant progress in their ability to track and enforce adherence to risk appetite

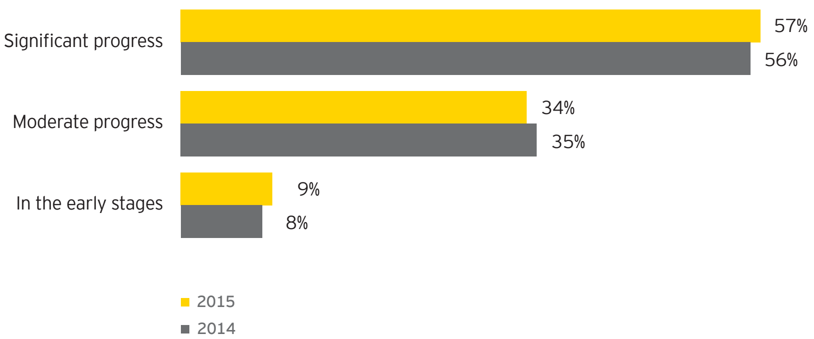
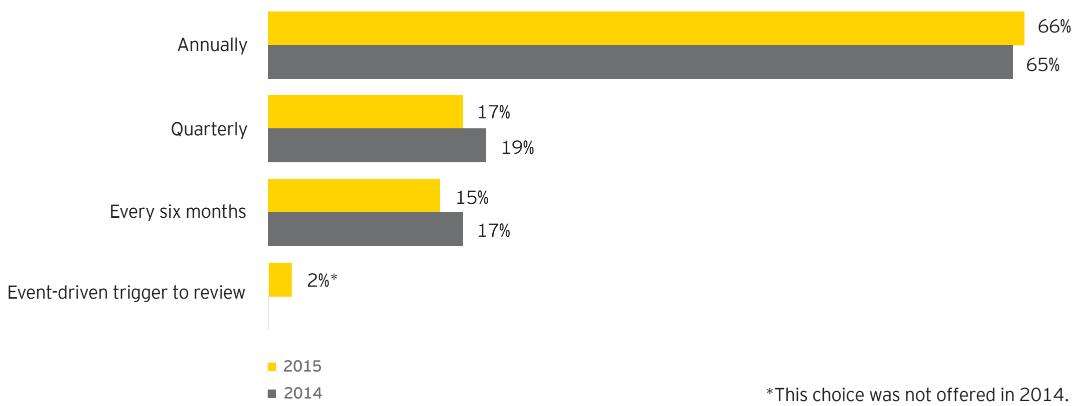


Exhibit 37: Most banks continue to review risk appetite progress on an annual basis



*This choice was not offered in 2014.

Exhibit 38: The majority indicate they have begun to create a risk appetite approach for non-financial risks, including conduct and compliance

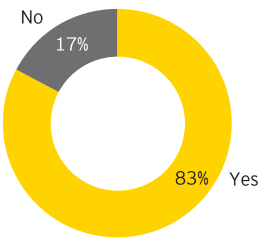
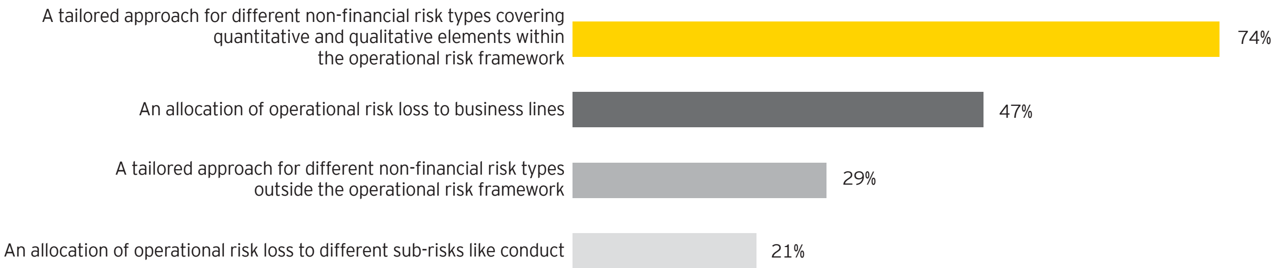
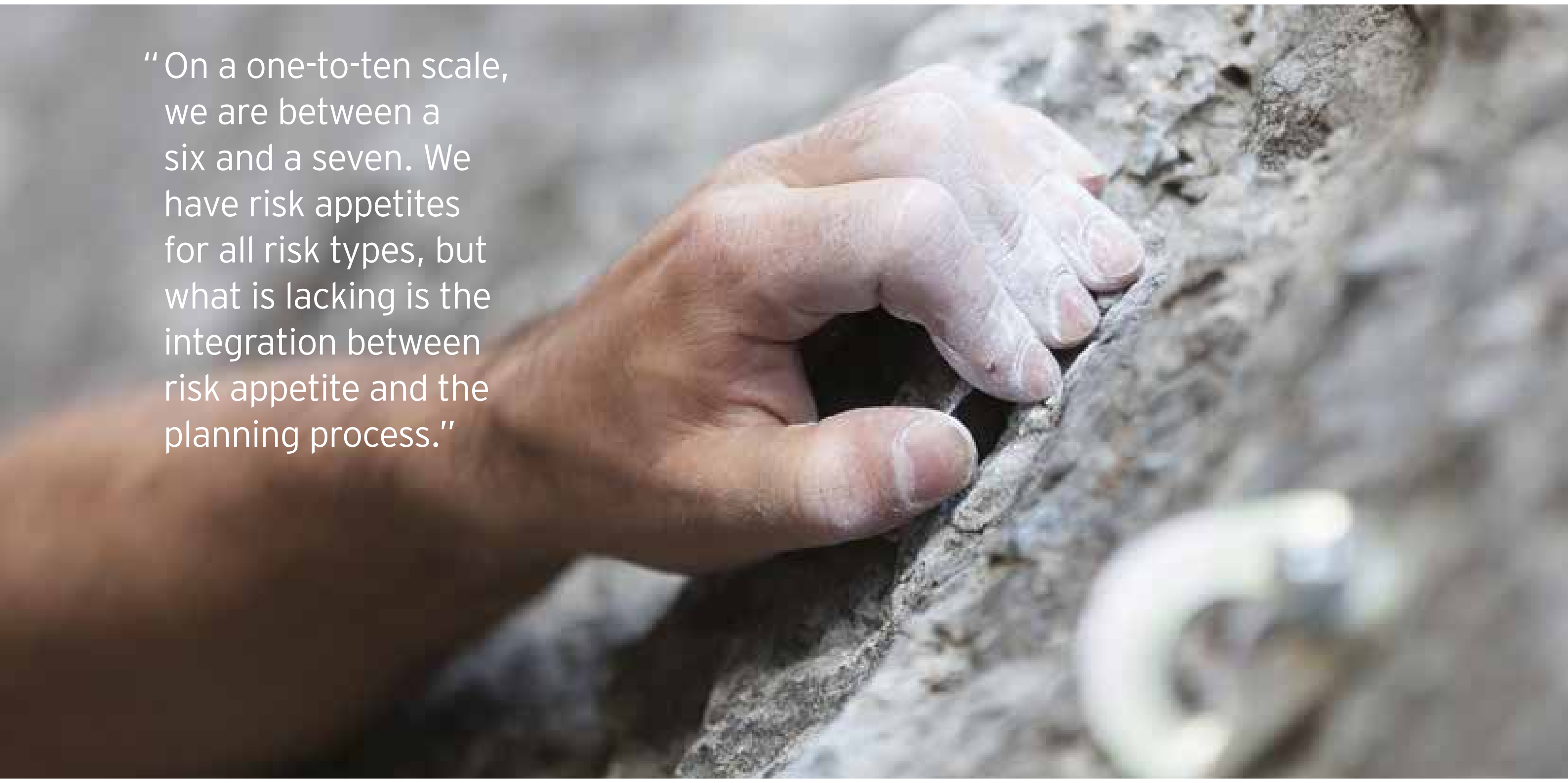


Exhibit 39: While approaches vary, the majority use a tailored approach for different non-financial risk types within the operational risk framework





"On a one-to-ten scale, we are between a six and a seven. We have risk appetites for all risk types, but what is lacking is the integration between risk appetite and the planning process."

Risk governance

Compliance risk is a major focus for both boards and CROs

Boards and senior management continue to face scrutiny and pressure from regulators, the media and the public to tighten internal controls and reduce high-risk behavior. The impact of rising litigation costs, steep fines and reputational damage has been a catalyst for firms to re-evaluate and strengthen risk governance frameworks. In last year's study, we reported some significant changes under way around risk governance. Many firms were in the process of adding new board and senior management committees to oversee and monitor ethics and conduct, streamlining and integrating current committees to break down silos and close the gaps in risk oversight and control, and increasing the role of the risk function in managing compliance. This year, firms are "buckling down" to implement and refine the changes initiated last year.

Board focus on compliance risk and management continues to increase

Reflecting the increased regulatory pressures and focus on risk management and control, 57% of the respondents listed compliance risk as the top area of increased focus for boards over the past 12 months, and 50% (up from 40% last year) reported they have made changes to the board to increase risk expertise (see Exhibits 40 & 41).

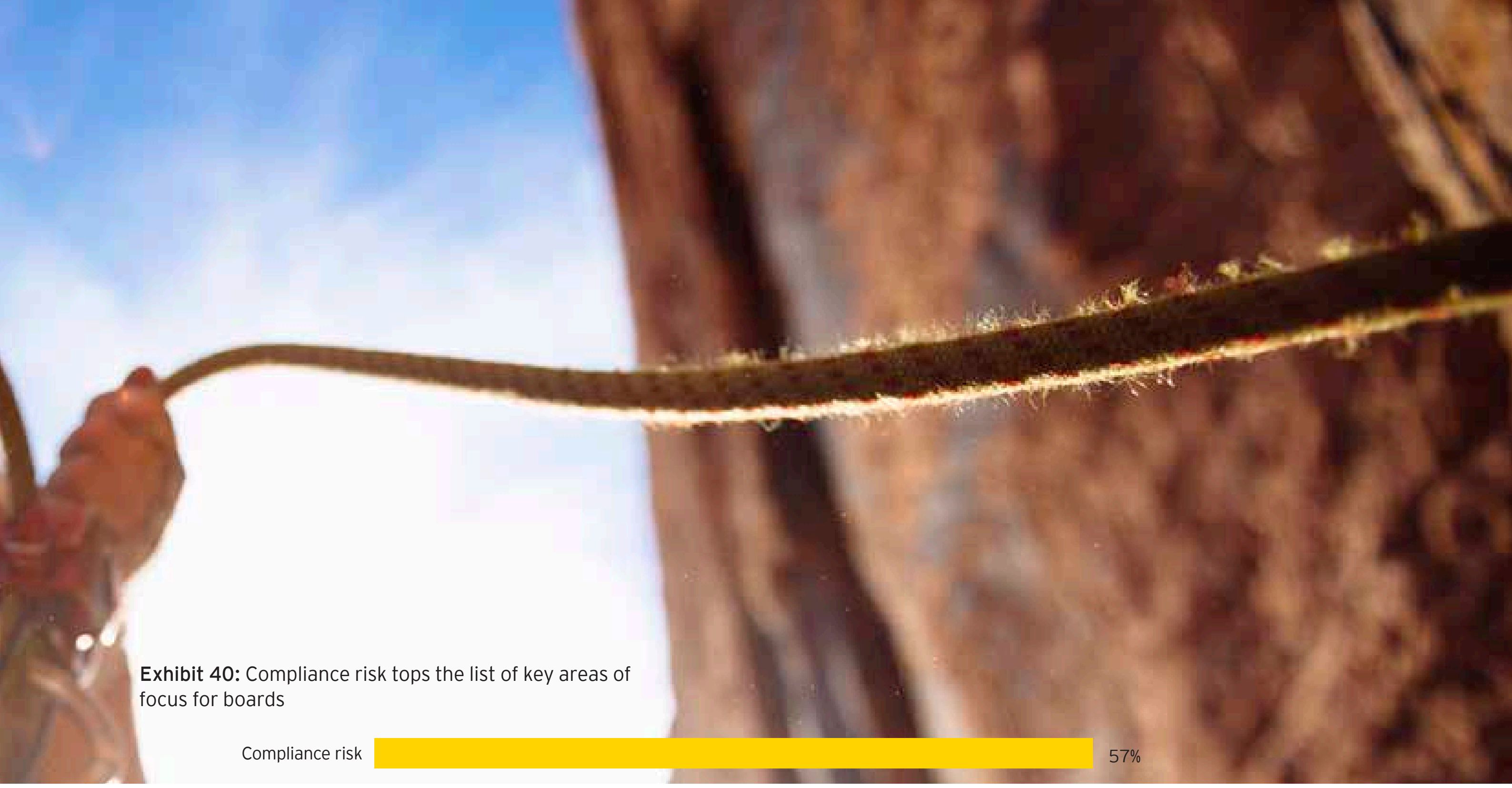


Exhibit 40: Compliance risk tops the list of key areas of focus for boards

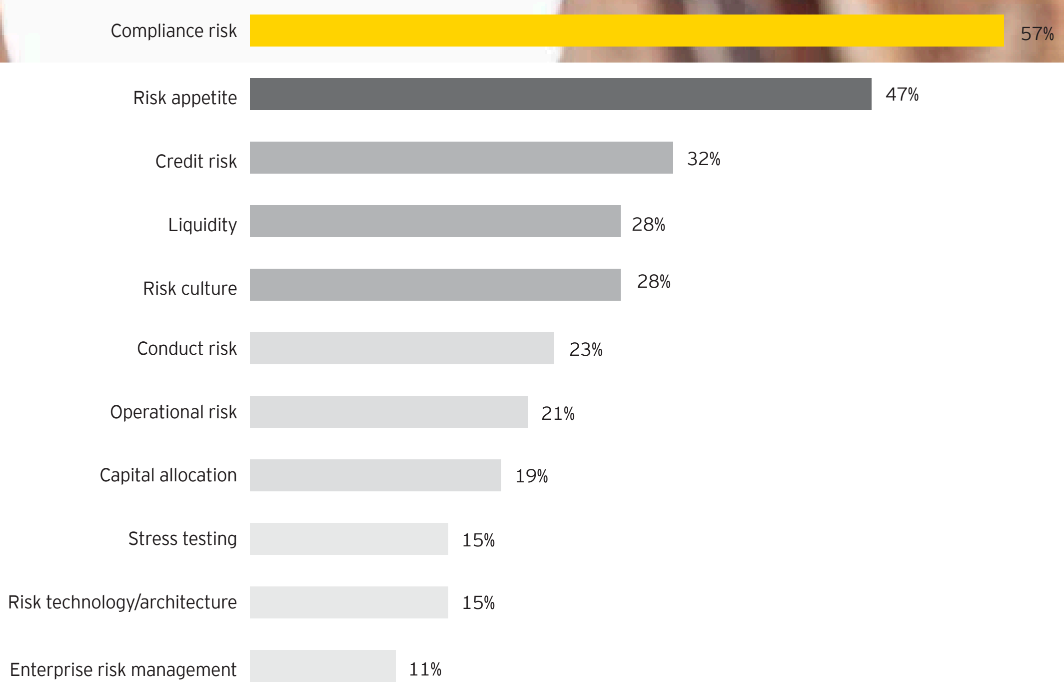
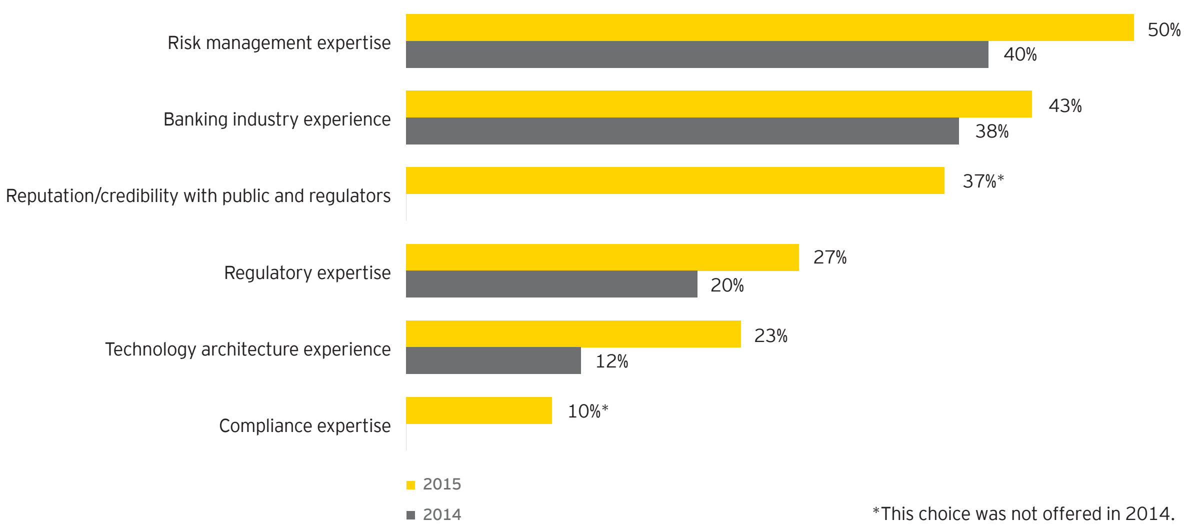


Exhibit 41: In the past 12 months, many have made changes to increase the risk management expertise of their boards



*This choice was not offered in 2014.

The CRO and risk function also increase their focus on regulatory compliance

In a significant shift from last year's study, participants reported a considerable increase in CRO attention to regulatory compliance, with 61% (versus 50% last year) listing it as the top area of focus for the risk function (see Exhibit 42). As in previous years, the executives interviewed continue to discuss the challenges they face in managing to the evolving regulatory environment. The strain on costs, resources and management time to meet the growing granularity of regulatory demands and reporting requirements is an ongoing issue. To meet the demands, firms continue to increase the size of teams, with no end in sight. Sixty-four percent (up from 57% last year) reported they have expanded the risk team over the past 12 months, with close to one-quarter (21%) indicating the increases have been as high as 20%. And 60% (up from 53% last year) anticipate these changes will continue (see Exhibits 43, 44 & 45).

Exhibit 43: The majority report an increase in the size of the group risk function in the past 12 months

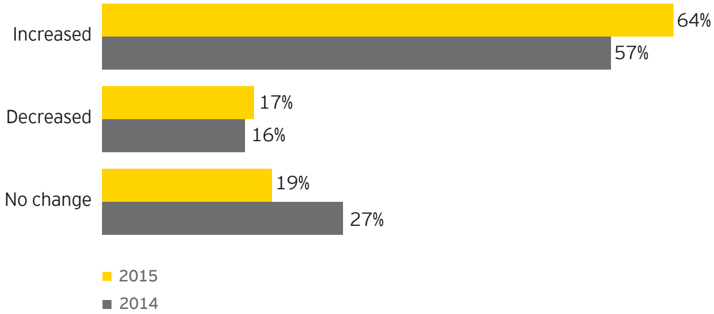
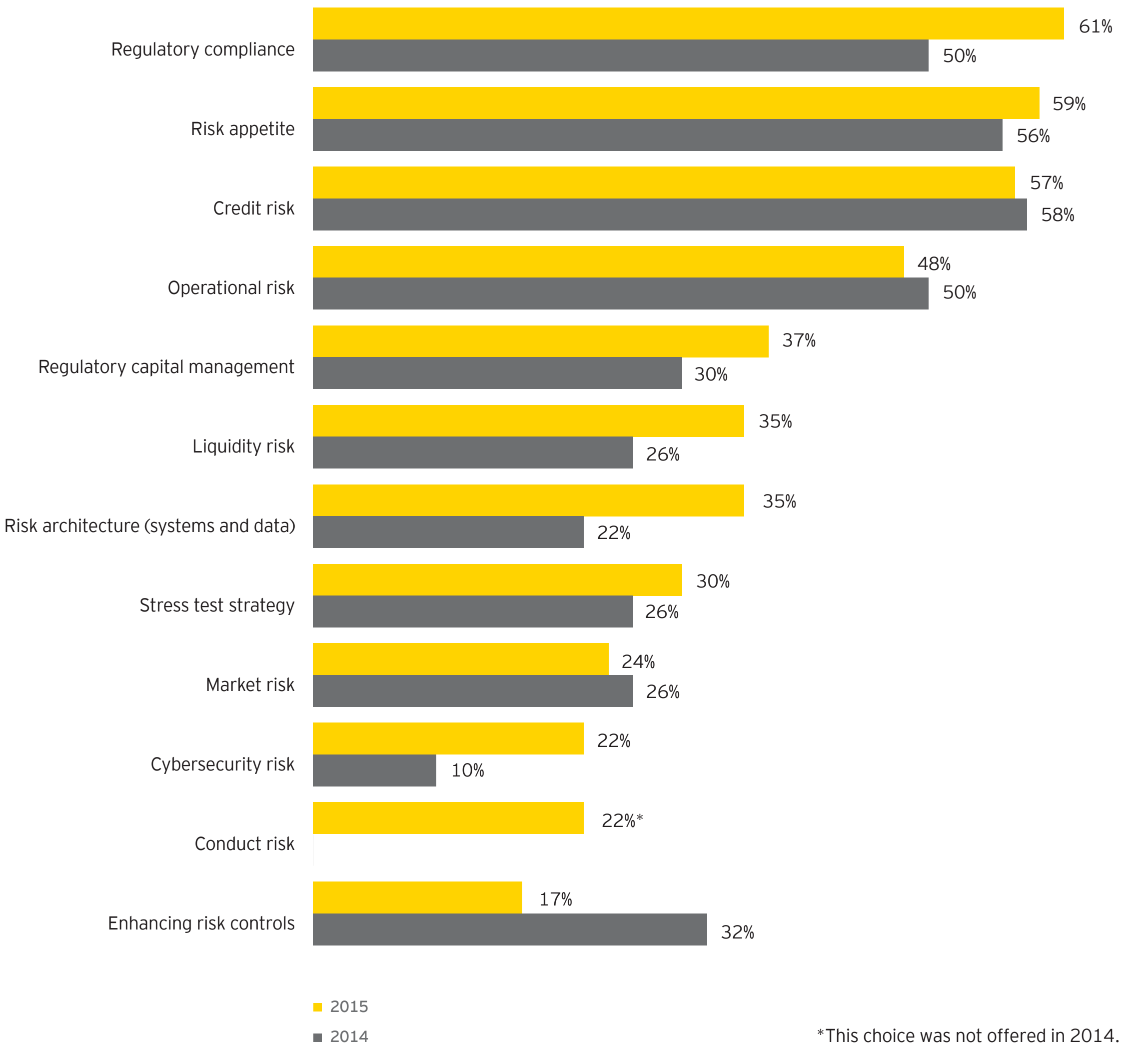


Exhibit 42: Regulatory compliance has risen to the top of the CRO agenda



*This choice was not offered in 2014.

Exhibit 44: Percentage increase in the size of the group risk function in the past 12 months

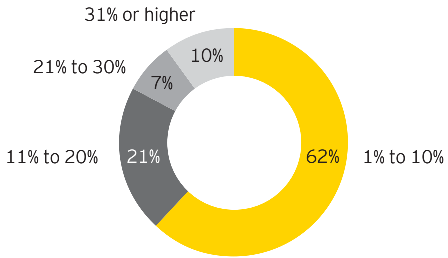
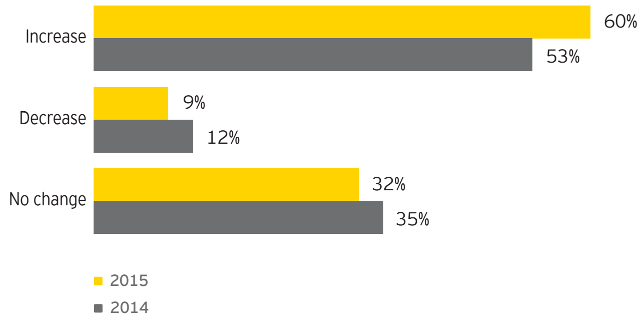


Exhibit 45: The majority anticipate that the group risk function size will continue to increase



Many participants discussed the difficulty of striking the right balance between managing risk and managing regulations. All agree that incorporating regulatory requirements into the strategy and day-to-day operations of the business is difficult, and many worry they are being pulled more and more into the role of "chief regulation officer" at the expense of focusing on the most significant risks in each business.

"The changes we have made to risk governance have been about aligning with market realities – with the growth areas we see in the market – and complying with the ongoing and increasingly complex demands from the regulators."

Internal stress testing

Banks are working to embed stress testing into business processes

Banks are continuing to improve stress testing methodologies and frameworks and are working to link stress testing to business planning. Eighty-one percent (up from 71% last year) of participants indicated that they have created and implemented new stress testing methodologies in the past 12 months (see Exhibit 46). Credit risk continues to be the top area for increased focus although it has decreased somewhat from last year (77% this year versus 81% last year). Liquidity risk, which was the top area of focus for many years post-crisis, remains in second place although the percentage has increased slightly from last year. Not surprisingly, given our discussions over the past two years on culture and conduct, the focus on operational risk continues to grow (see Exhibit 47).

Exhibit 46: The majority of banks have implemented new stress testing methodologies in the past 12 months

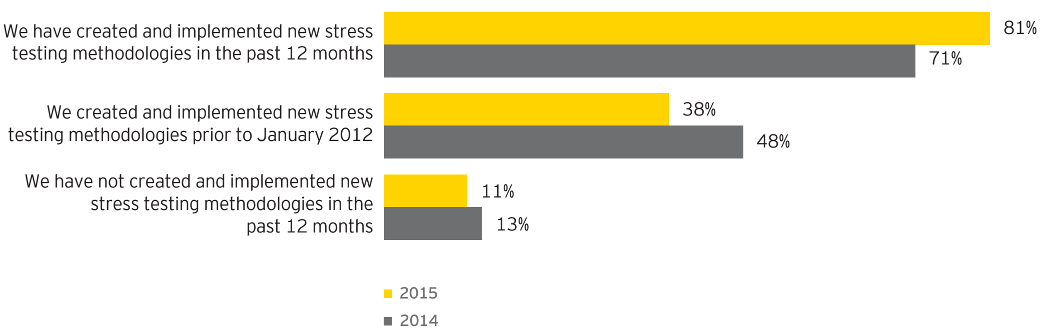
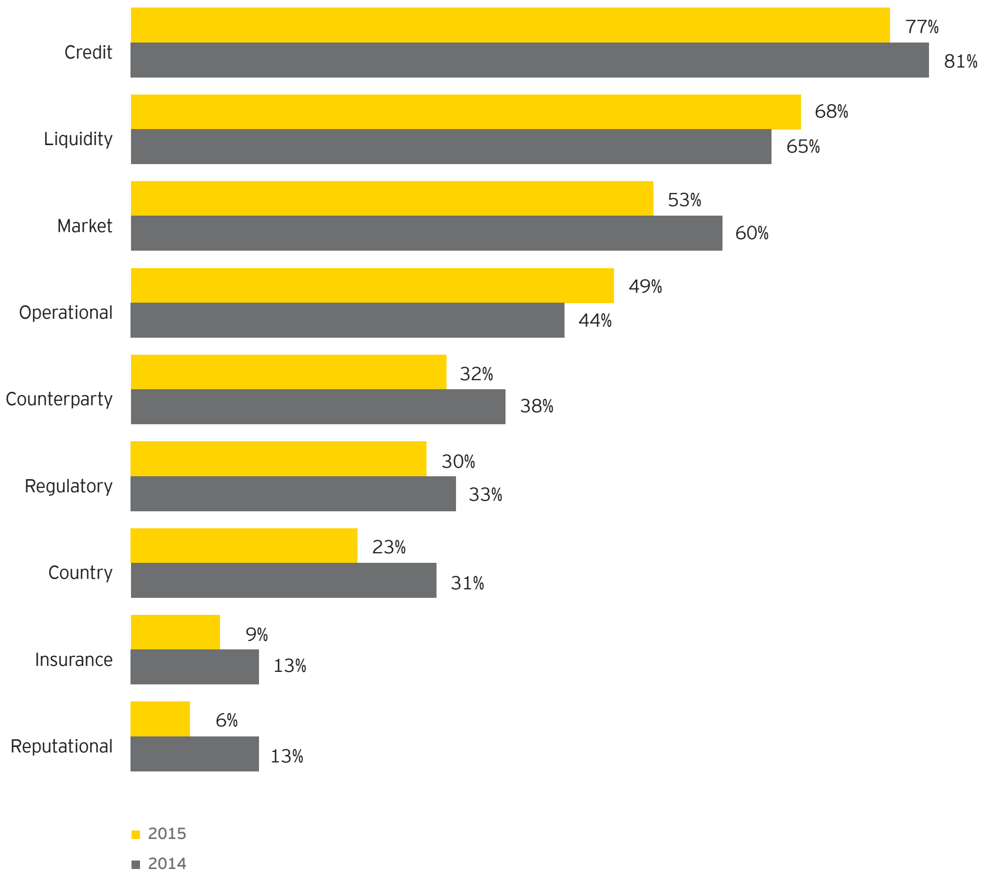


Exhibit 47: Credit remains the top risk area where focus on internal stress testing has increased in the past 12 months



Stress testing is growing in importance as a strategic management tool, but it still has a way to go to be fully incorporated into business decision-making

Banks are becoming more sophisticated in the way they are incorporating stress testing into the strategic management of the business. As can be seen in Exhibit 48, stress tests are a core management tool in risk management, capital planning and risk appetite-setting and management. Still, stress testing continues to be undervalued as a guide to many business decisions. Only 34% of respondents reported that stress testing is incorporated into business-unit planning, down slightly from last year, and even fewer incorporate stress testing into decisions on acquisitions or new products. And in what may appear to be a disappointing setback, over half (55%, up from 49% last year) report that stress testing is only "somewhat incorporated" into strategic management decision-making (see Exhibit 49). As one executive noted, "What's our biggest challenge to stress testing? Using the results."

Exhibit 49: 55% say that stress testing is only somewhat incorporated into strategic decision-making

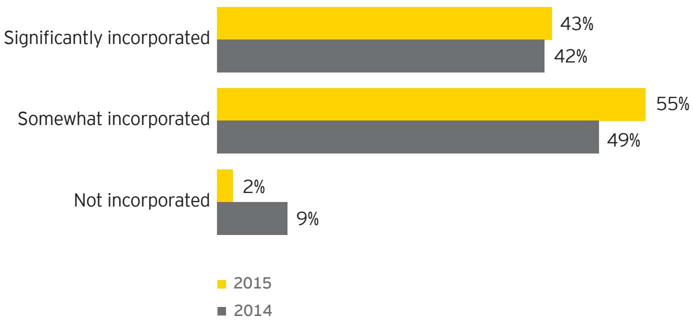
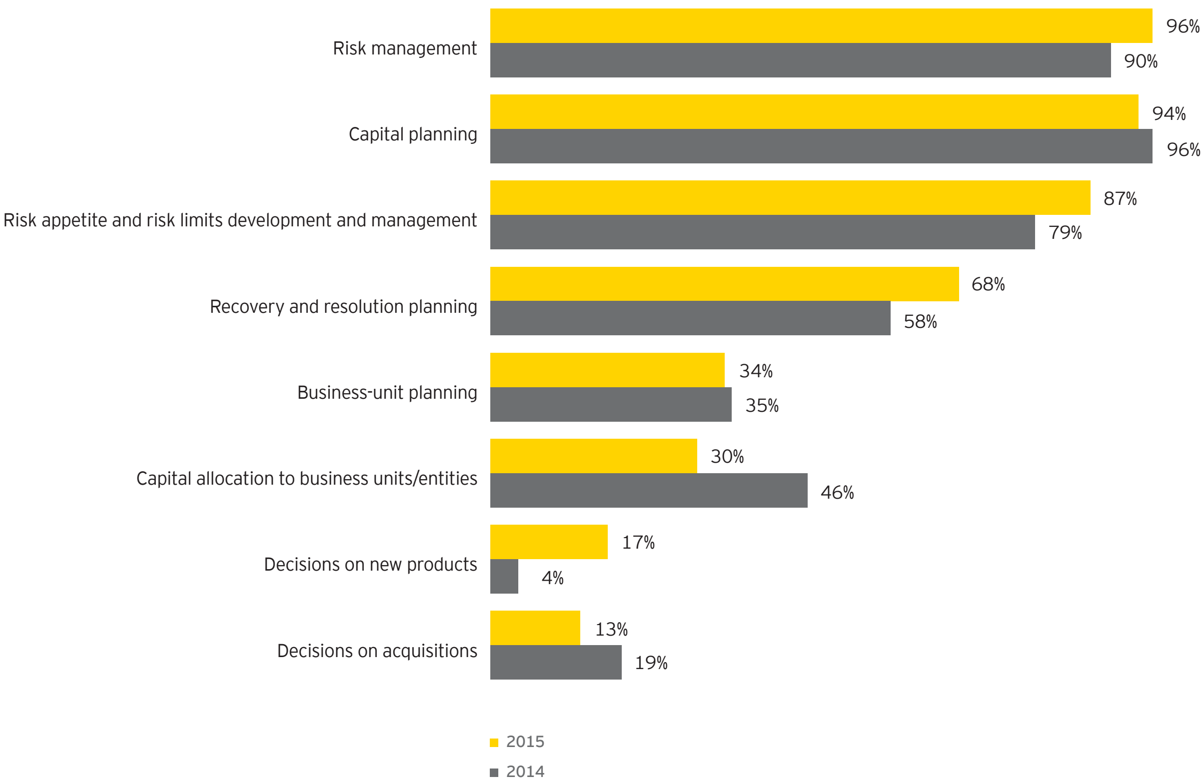


Exhibit 48: Risk management, capital planning and risk appetite are the top areas where stress testing is incorporated



Methodologies of stress testing point to a maturation of approaches

Over the past several years, banks have been decreasing their use of economic capital models to run internal stress testing in favor of much more granular, risk-sensitive methods. Since last year, there has been a greater focus on stressing internal ratings-based (IRB) models for credit portfolios and sub-portfolios, with a slight decrease in central testing models (see Exhibit 50). Sixty-six percent of participants (up from 50% last year) reported they have increased the severity of scenarios, and once again, we see an example of the heightened focus on non-financial risk management, with 55% (an increase from 48% last year) indicating they incorporate operational risk events into scenario planning (see Exhibit 51).

Exhibit 50: Banks are using a variety of methods for running internal stress testing

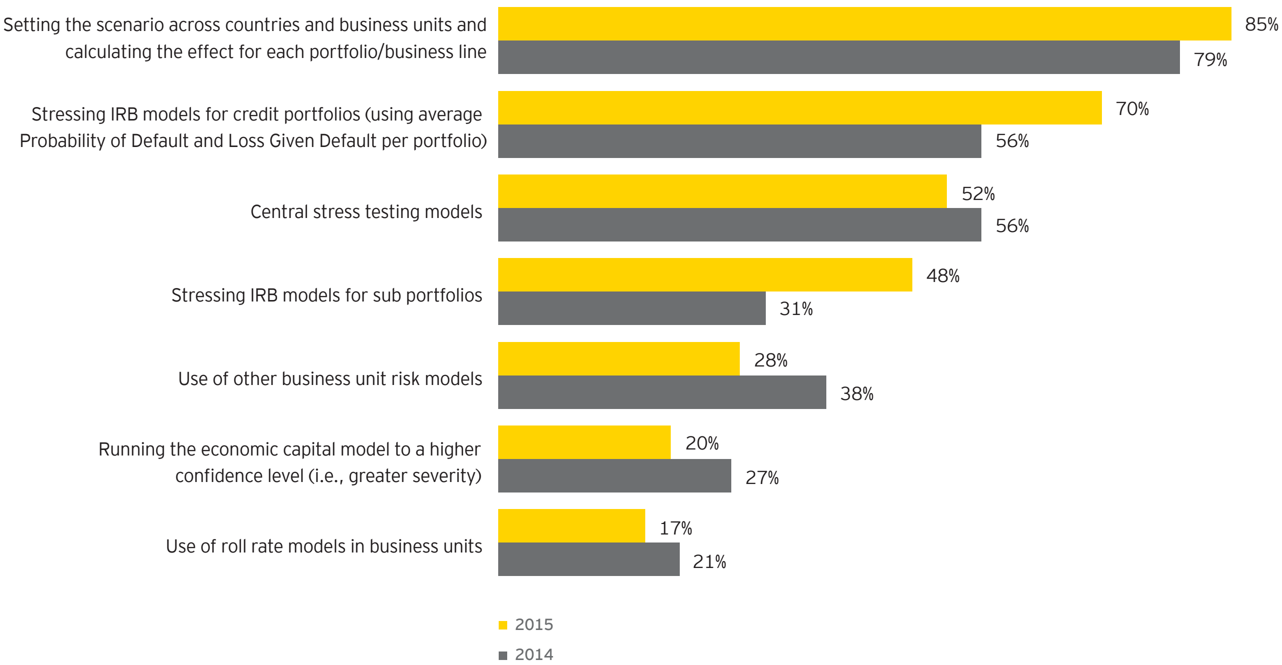
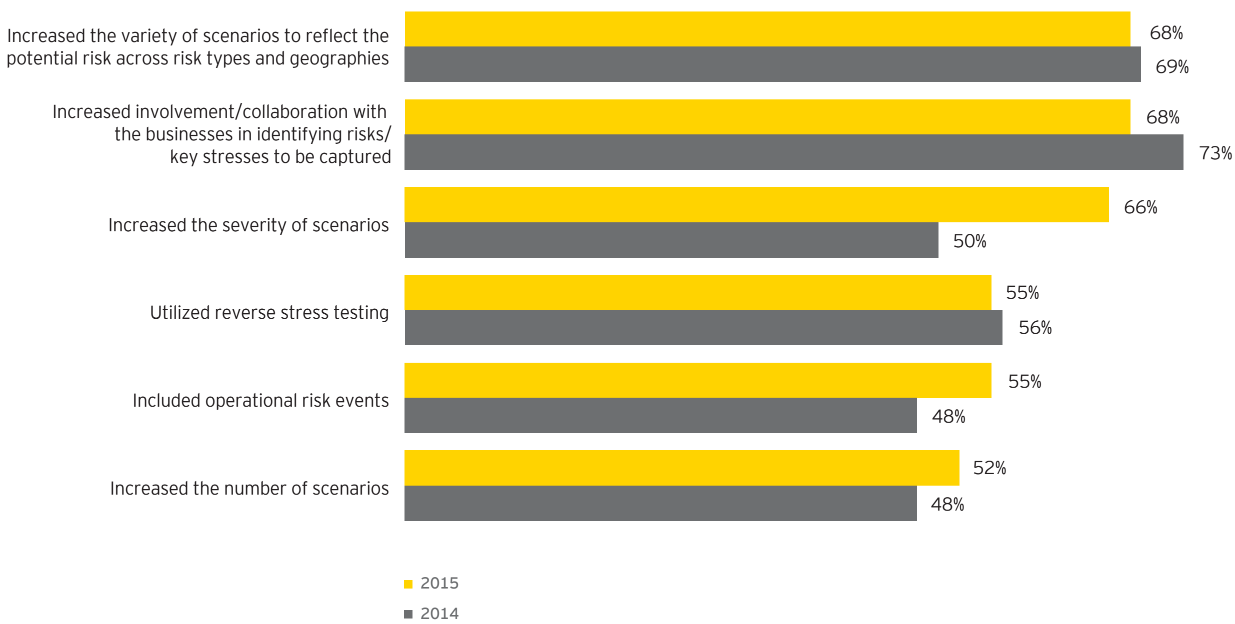
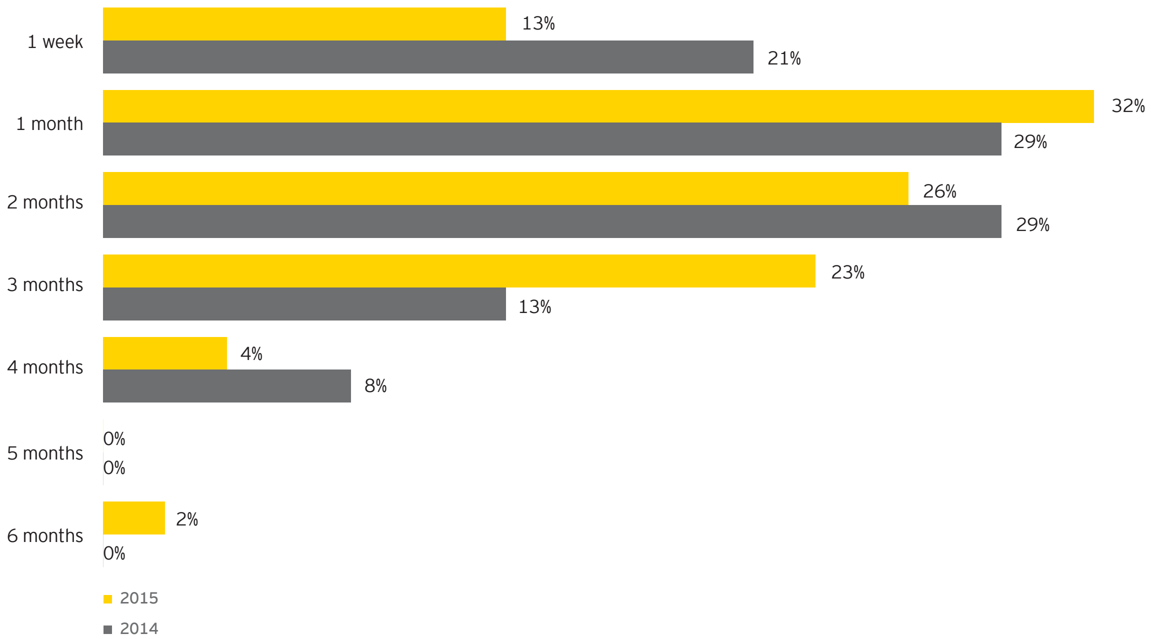


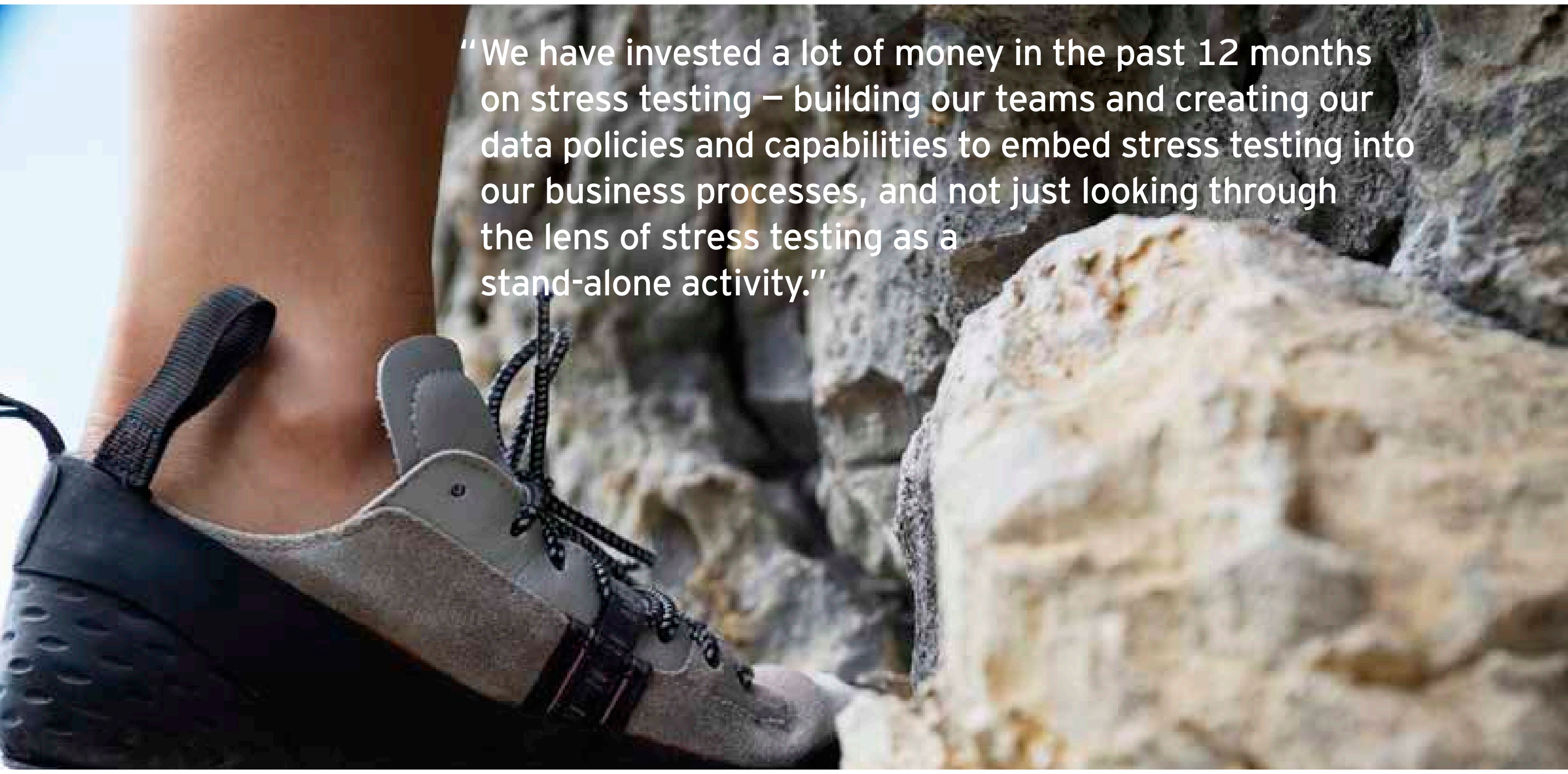
Exhibit 51: Banks have incorporated multiple areas into scenario planning



The time to complete a group-wide stress test continues to be a pain point for many banks: for most, it takes one to two months (see Exhibit 52). Many believe that the time it takes to get results is a barrier to using the output as an effective management tool although some say that results produced more quickly are not comprehensive. Most agree that automating what is often a manual process of conducting tests and gathering results across portfolios and businesses would yield results more quickly and cheaply and make them more useful as management tools. However, investment in such automation must compete with the many regulatory requirements for IT and data development.

Exhibit 52: More than half need one to two months to complete a group-wide test

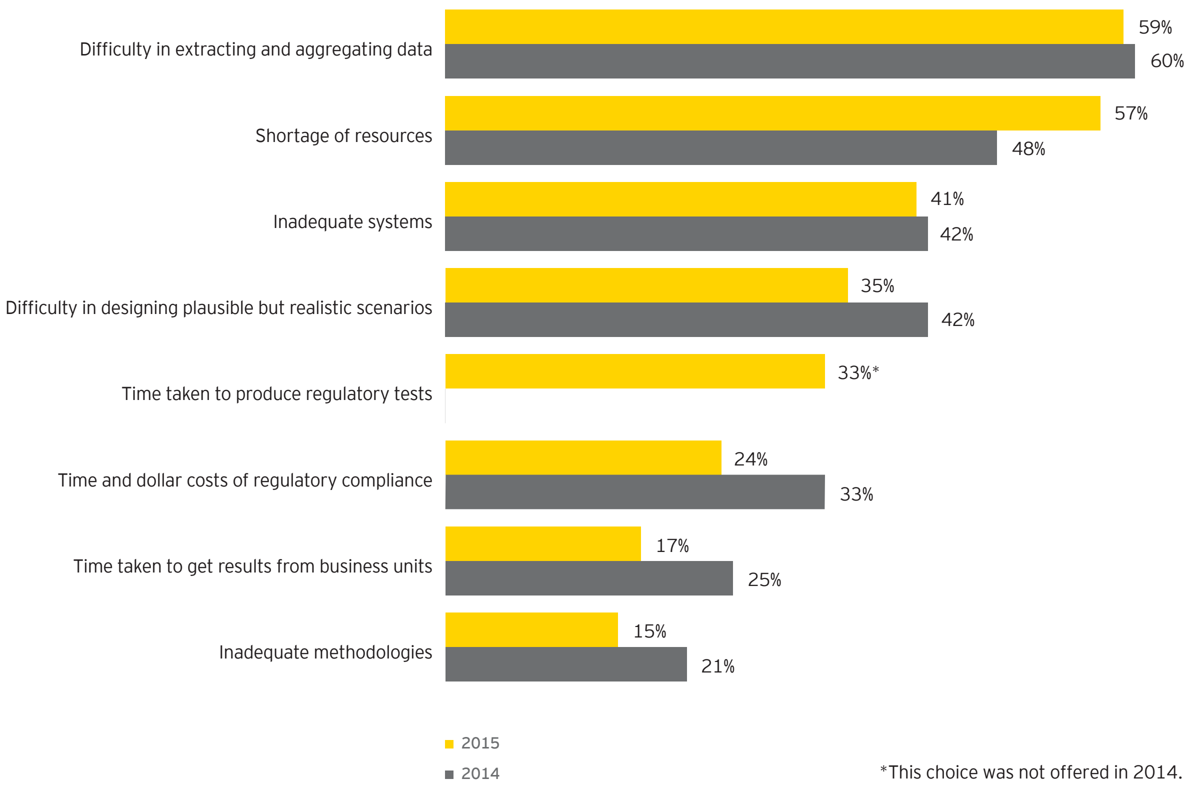




Top challenges reflect the complexity of stress testing

Extracting and aggregating data continue to be top challenges to improving stress testing, followed by a shortage of resources and inadequate systems (see Exhibit 53). Finding and aggregating accurate, quality data from siloed legacy systems have been issues for many years. While many firms have made significant progress, it is a massive, multiyear, costly endeavor. Many executives emphasized the impact of regulatory data and stress testing requirements on the capacity to run stress tests driven by internal needs. Regulatory tests, data and IT requirements under different standards can monopolize resources, particularly at global banks that must meet a variety of different stress testing requirements from multiple authorities.

Exhibit 53: Data and lack of resources remain top challenges to improving stress testing



*This choice was not offered in 2014.

Impact of Basel III

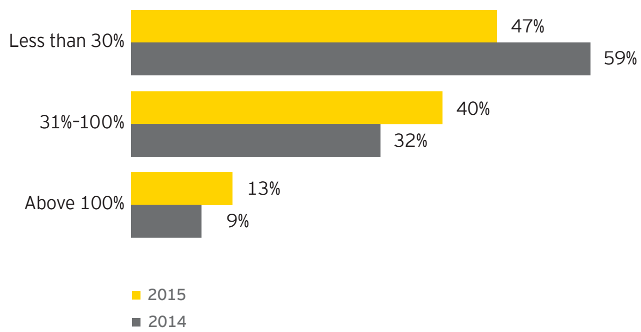
The industry is facing widespread business-model change

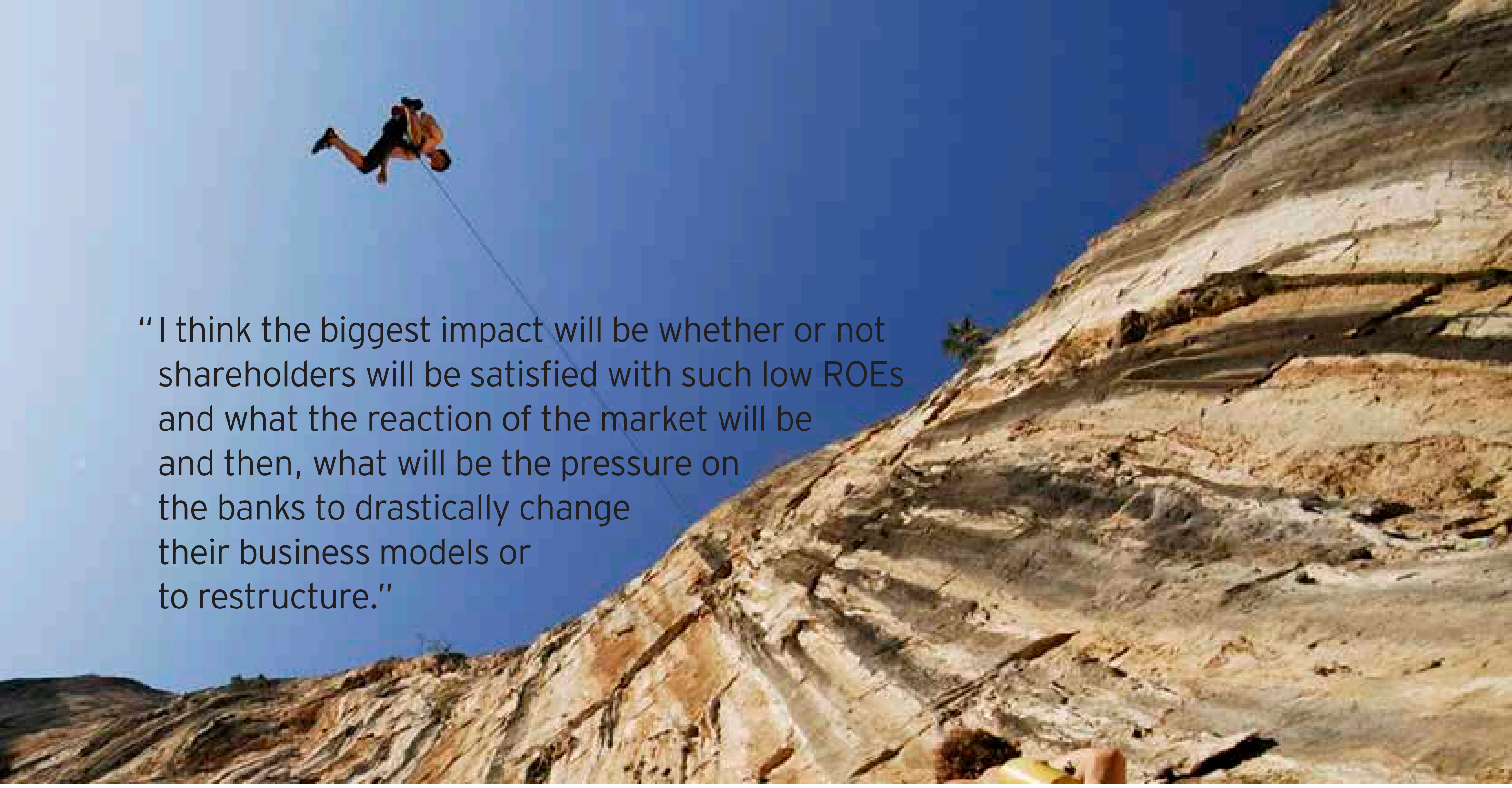
As we have reported over the years, the strategic changes that have been implemented as a consequence of regulatory developments have been significant for many banks. Most of the firms in this year's study have completed or are close to completing overhauls of systems and processes to comply with the Basel III requirements. However, the impacts of the mandated Basel III changes on profitability are still reverberating throughout the industry. The survey shows that investors are still not accepting lower ROEs and are putting pressure on banks to improve profitability. As a result, many firms are continuing to assess and adjust their business models in an effort to boost return on capital.

Effect of Basel III on capital and liquidity

Basel III has resulted in major increases in common equity Tier 1 capital at most banks (see Exhibit 54). More than half see increases of above 30%, and for some banks, 100% or more. This is creating pressure on banks unable to fully remunerate the required capital. Investors are not accepting lower ROEs, despite the risk reduction created by the stronger capital and liquidity buffers.

Exhibit 54: Impact of Basel III plus G-SIFI requirements on the amount of common equity Tier 1 capital





> "I think the biggest impact will be whether or not shareholders will be satisfied with such low ROEs and what the reaction of the market will be and then, what will be the pressure on the banks to drastically change their business models or to restructure."

The Basel III liquidity rules and the general increase in banks' liquidity positions are also among the factors behind pressure on profitability. Under the Basel III liquidity coverage ratio (LCR), being phased in from this year, banks are required to hold substantially more high-quality, low-yielding liquid assets to cover assumed stress outflows of funds. Forty-four percent of respondents estimate that under the LCR, 10%–20% of the balance sheet will have to be composed of liquid assets, with over one-third (35%) estimating more than 20% (see Exhibit 55). While this will help to insulate the industry from liquidity pressures, it reduces the portion of the balance sheet available for lending and reduces the overall return on the balance sheet. In addition, the net stable funding ratio (NSFR), scheduled to be introduced at a later date, would require many banks to increase the proportion of funding classified as stable, which would constrain market activities. However, this year's survey shows a sharp fall, to 50%, in the proportion of banks that believe stable funding can be increased, down from 70% last year (see Exhibit 56). This could have implications for capacity to conduct longer-term lending, which banks will have to back with stable funding.

Exhibit 55: Percentage of the balance sheet that will be accounted for by the liquid assets (under the LCR regime)

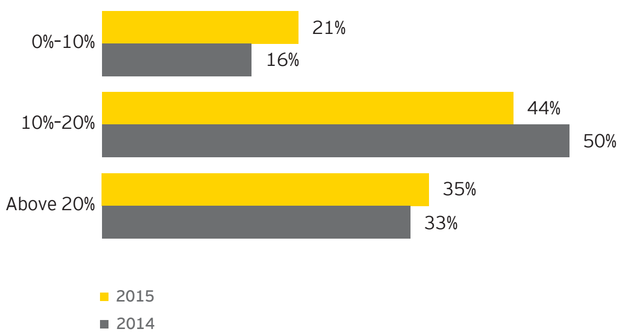
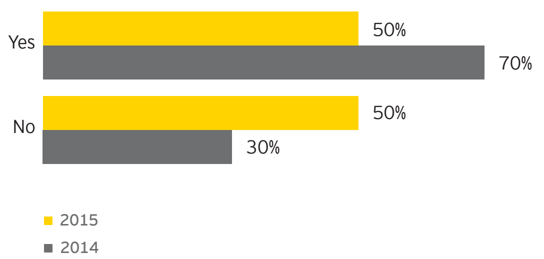


Exhibit 56: Will you be able to increase the proportion of your funding that is stable, as defined in the NSFR?



Forty-eight percent of non-G-SIFIs and 69% of G-SIFIs agree that the combined liquidity and capital changes under Basel III will have a significant effect on the cost of doing business (see Exhibit 57). And, as discussed earlier, this is leading to substantive changes in business models.

Banks are continuing to push down the target ROE, with 63% of G-SIFIs and 40% of non-G-SIFIs targeting returns of 10%–15% (see Exhibit 58). This is a significant decrease from pre-crisis, when more than 70% of banks targeted ROEs of more than 15% (see EY's 2014 risk management survey, *Shifting focus: Risk culture at the forefront of banking*). However, some banks are finding even these new lower levels of ROE hard to achieve.

Investor pressure to improve performance is on the rise

The study results point to continued reluctance from investors to accept lower ROEs despite the improvement in resilience that is the fundamental aim of the Basel III reforms. Banks are under pressure to improve profitability and increase efficiencies in business models. As one executive explained, "Investors are obviously concerned about returns. They want to see some dividend flow, but if the capital bar keeps going up every time there is a rule change, it's tough for them to

Exhibit 57: Will the combined liquidity and capital changes under Basel III have a significant effect on the costs of doing business?

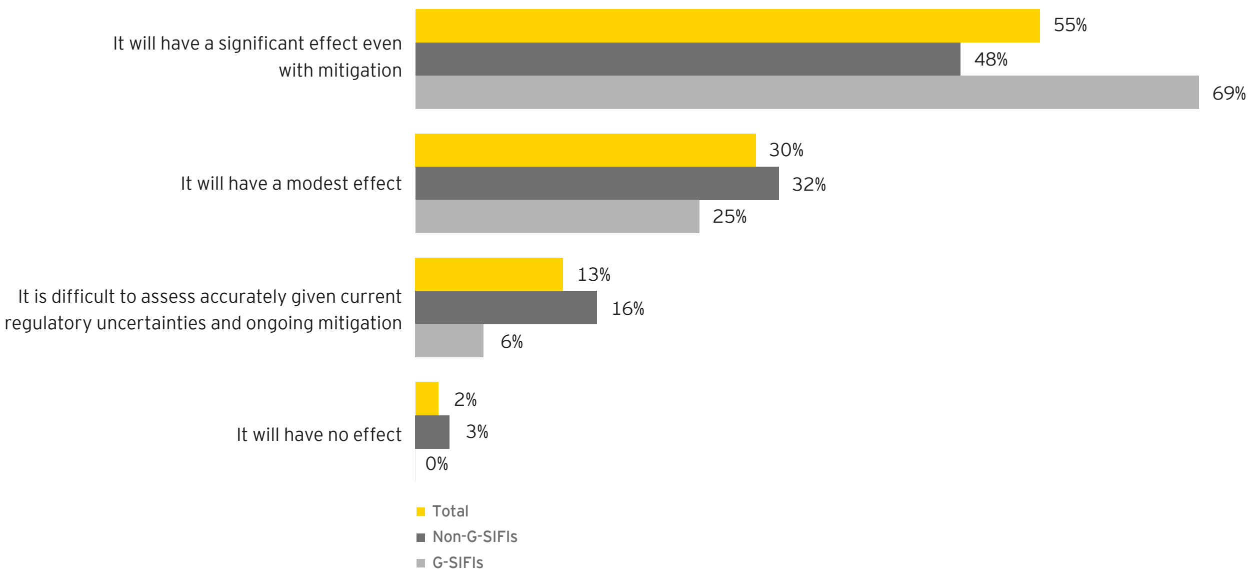
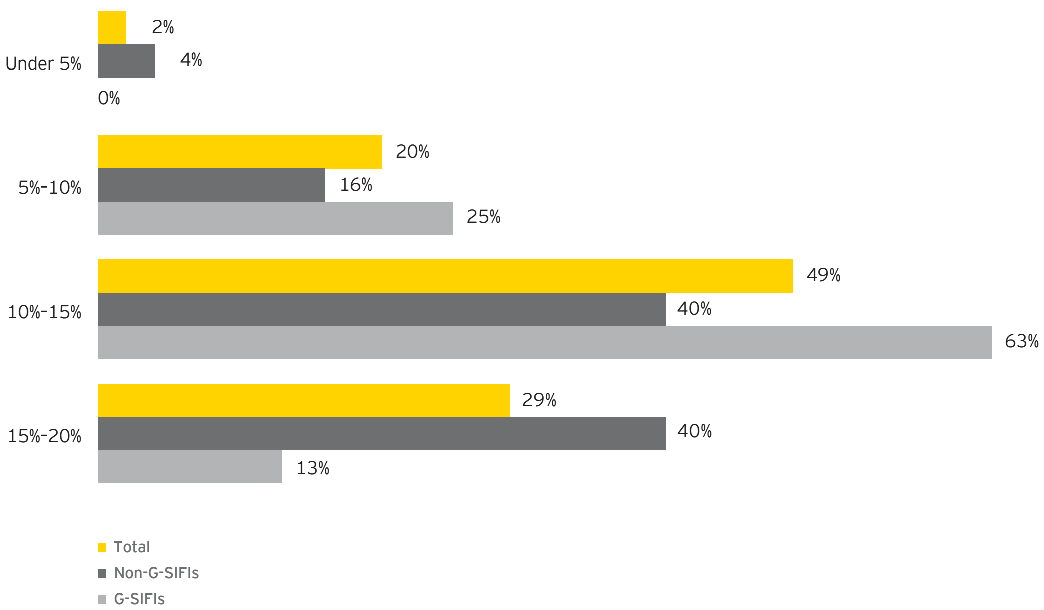


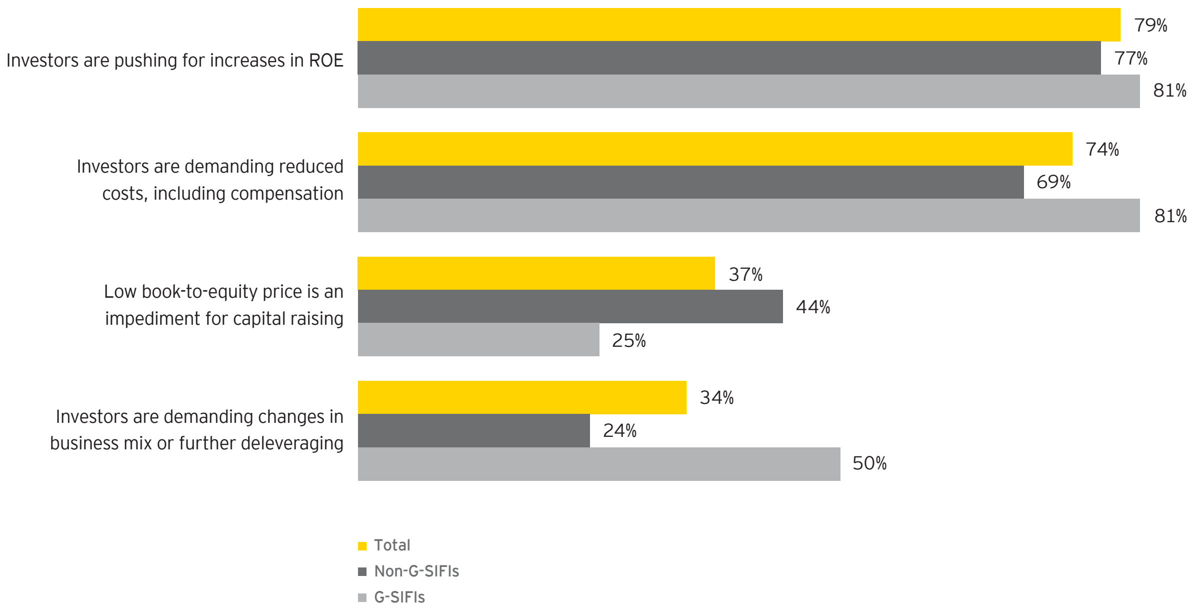
Exhibit 58: Targeted ROE



see even a cash return from dividends. And even if the equity number keeps going up, nothing is really going to change in terms of returns unless you find a different way to do business, or a different business mix." Some interviewees think that investors are confused by mixed messages from the regulatory and political initiatives that pull in different directions. As one executive remarked, "On the one hand, there are liquidity initiatives to foster loan growth, and on the other hand, there is an increasing demand for higher capital levels. Investors are concerned that too-high capital levels will eventually transform the financial industry into a type of utility investment." There are also indications that some investors are not convinced about the strategies, particularly growth strategies, of some banks.

The survey shows that for almost 80% of respondents, the investors are pushing for increases in ROE, and for three-quarters, they are pressing for cost reductions (see Exhibit 59). The challenge for banks is to balance this increased pressure from investors to improve performance

Exhibit 59: Investors have many concerns

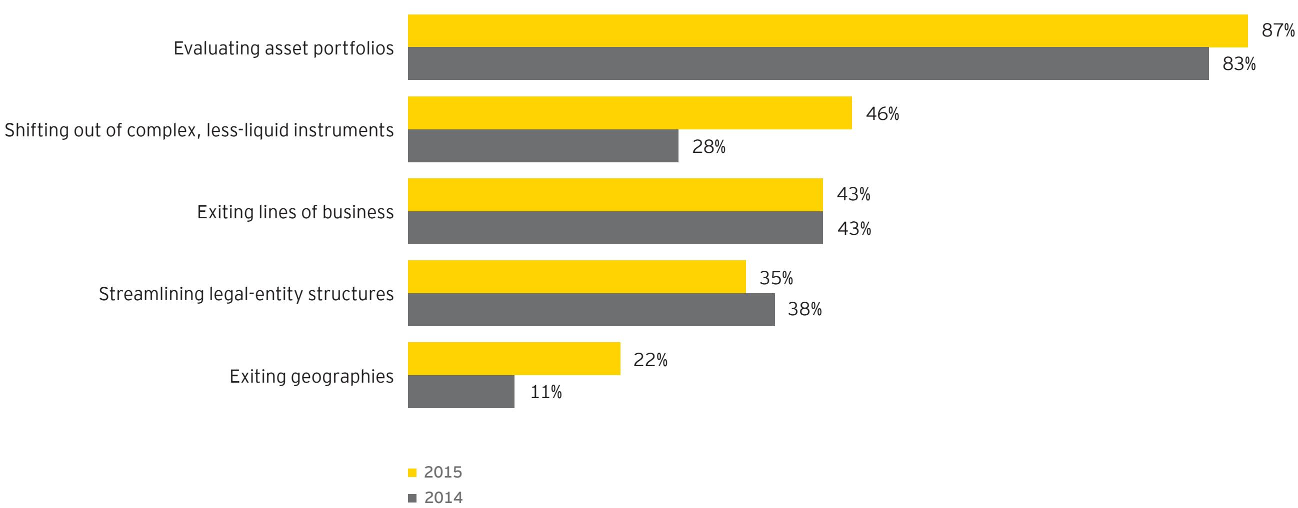


with the regulatory pressure to re-engineer the business with improved IT systems, data, risk and compliance controls, all of which add significant cost. In addition, the firm culture and conduct programs have caused some firms to reduce customer and sales targets in order to change behavior.

Business-model change

These pressures are resulting in intensified business-model change. One bank executive said that, "if the ROE on any activity that you are conducting is less than your cost of capital, it's the activity that's going to change." Eighty-seven percent of this year's respondents (up from 83% last year) are evaluating their asset portfolios to better understand the links, interdependencies and trade-offs among segments, as well as the relative costs, profitability and strategic importance of each and the consequences of retaining them. As a result of these evaluations, an increasing number of firms (46% this year versus 28% last year) are shifting out of complex, less-liquid instruments, and many are continuing to exit business lines and countries (see Exhibit 60). Indeed, the percentage leaving countries has doubled to 22%. As one executive said, "It has become very apparent under Basel III that we have to be very disciplined about which businesses in our portfolio have scale and make a decent return and which don't. We have stopped doing the ones that no longer make sense." In addition, recovery and resolution planning, as well as pressure on costs, is leading firms to simplify legal-entity structures.

Exhibit 60: Firms are considering a host of changes to their business models under Basel III



Changes in charging

In response to pressure on profitability, banks are changing charging strategies on both sides of the book. Many firms continue to institute more stringent liquidity charging structures, both externally, with counterparties and customers, and internally, with businesses. Fifty-seven percent have made changes to their counterparty and customer charges in the past 12 months, an increase from 51% last year. These changes have focused on increasing charges on both lines of credit and drawn lines (see Exhibits 61 & 62). Interestingly, more than one-third of G-SIFIs report they have not made any changes to these charges over the past year versus only 20% of non-G-SIFIs, indicating that the larger banks have been more proactive in adjusting to Basel III pressures on profitability.

In addition, over half of the participants predict that they will increase the charges on corporate loans. However, many firms, particularly the G-SIFIs, remain uncertain about the ultimate extent of these increases (see Exhibit 63).

Exhibit 61: Over half have made changes to counterparty/customer charges in the past 12 months

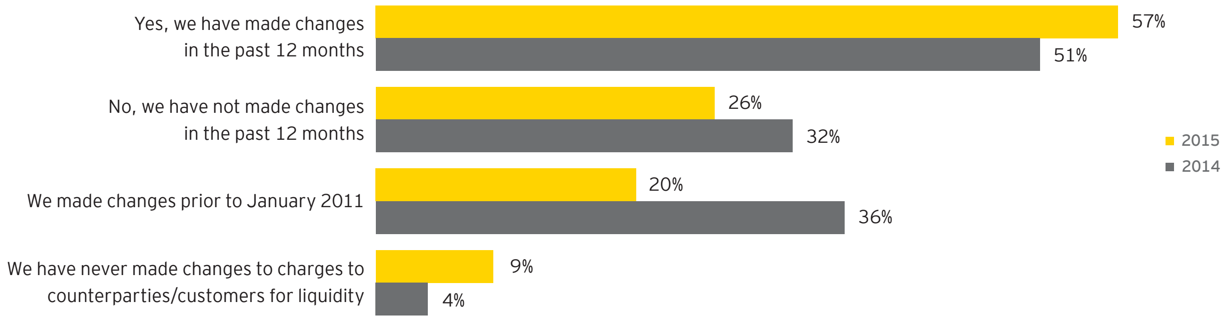


Exhibit 62: Changes made to counterparty/customer charges vary

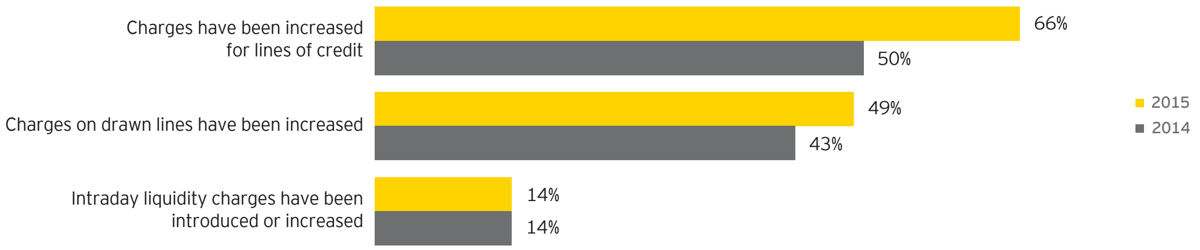
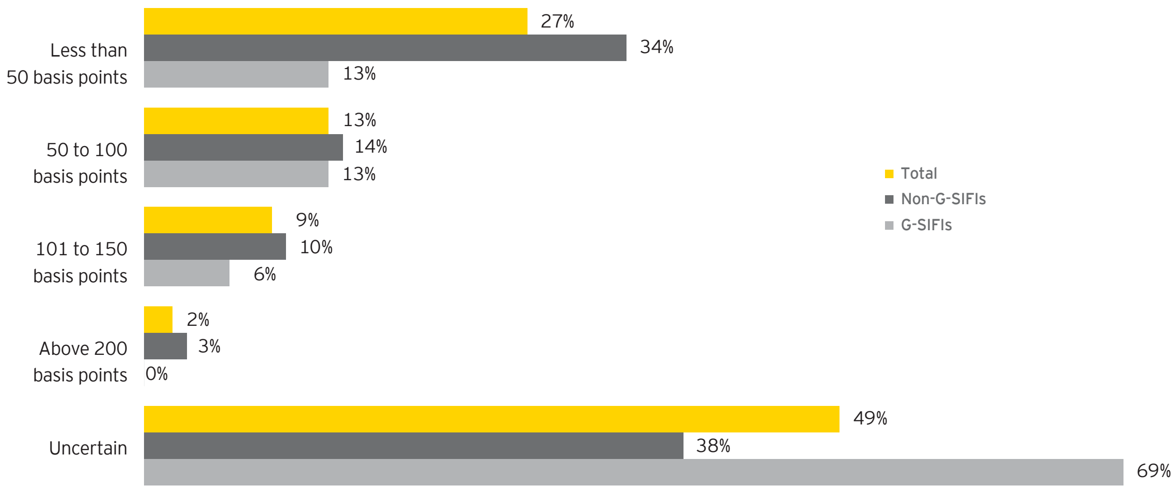


Exhibit 63: Expected effect on margins of unsecured corporate loans due to higher costs under Basel III



Changes in funding models and management

Banks are also changing funding models. The survey shows that banks are continuing to shift away from managing liquidity at a group level to a more layered approach that includes funding at both group and local-entity levels. Seventy-six percent of participants are currently using this approach to manage funding (up from 66% last year), and 83% (up from 80% last year) are expecting to do so in the future (see Exhibit 64). There are two factors driving this shift. The first is the need to create more funding sources across a wider range of markets and currencies to reduce dependence on home currency financing, which argues for more funding at the subsidiary level. The second is that local regulation of entities has in some jurisdictions encouraged a more stand-alone liquidity focus, partly in response to the drive to improve the resolvability of both groups and local entities. Also, regulators in some jurisdictions are requiring some branches to convert into stand-alone subsidiaries that will require local funding. As a result, a number of banks are seeking longer-term financing by issuing paper in different markets.

Exhibit 64: Level of current and future management of liquidity

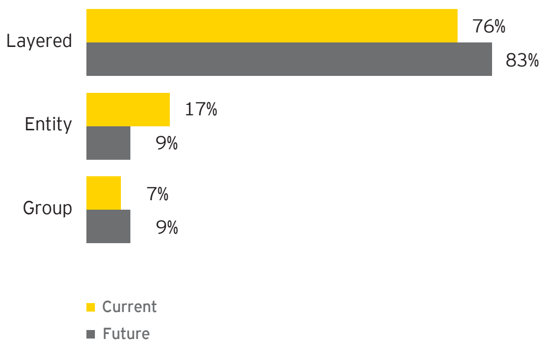
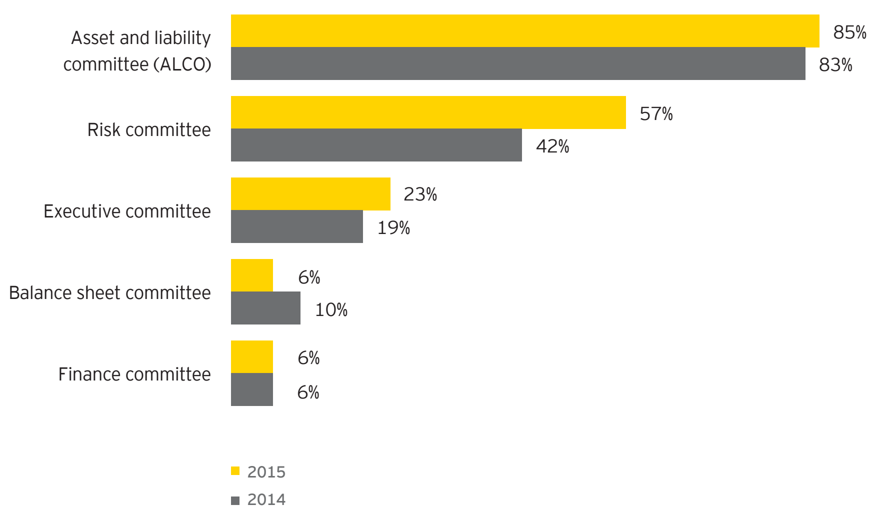


Exhibit 65: Committee responsible for liquidity risk



Banks are increasingly moving to making multiple committees responsible for liquidity risk. Although the vast majority (85%) of banks still have responsibility sitting with the asset-liability committee (ALCO), well over half have some liquidity risk oversight by the risk committee; over one-third have the involvement of another non-ALCO committee; and for almost one-quarter, the responsibility rests with the executive committee. Although ALCO has the day-to-day management of funding and liquidity risk, the other committees are assessing the liquidity risk profile that comes out of the strategy (see Exhibit 65).

Regulatory inconsistency continues to challenge the industry

While many executives agree that capital and liquidity regulation needed to be reformed after the crisis, many remain concerned about the impact of the continuing regulatory changes, as well as the need to manage the multiple and inconsistent regulatory requirements around the world. One executive explained his frustration: "I am staggered by the regulatory change agenda and its impact on our organization. So I am going to be spending the available risk dollars on changing our models and systems to meet whatever the next rules are, rather than building up better data and better stress testing and making other investments in better risk management for our firm."

The expectation is that over the long term, the pressures will lead to greater consolidation in the industry. Indeed, one bank respondent said that "only entities with a deep knowledge of their risk will be in a good position to survive, and the rest will be 'concentrated'."

In summary, the changes that have been made and continue to be initiated under Basel III and related regulatory reforms, such as recovery and resolution planning, have been significant for many firms. The pressure to balance strong management practices around culture and conduct, combined with investor pressure to improve profitability, presents a challenge. And, while many firms believe they have now adjusted their systems and processes to meet the Basel III requirements, further changes have still to be worked through, making the full consequences hard to assess.

Conclusion

A consistent theme in this year's survey is the degree to which firms are rethinking their approach to managing non-financial risk

Almost all banks have increased the focus on non-financial risk, and many are now looking at it in a more granular way, by sub-risk types such as conduct, compliance, reputation, money laundering and systems. Non-financial risks such as conduct are now a top issue because of the range of adverse events that have come to light and the huge losses to the industry from a variety of conduct and compliance events with sizable financial and reputation costs. Conduct risk management, in particular, is a high priority, with many reporting activities to identify and reduce the intrinsic risks inherent in current business models, including exiting types of products and markets, changing incentives and adjusting revenue and sales targets. Additionally, many institutions have implemented new product development approval and oversight processes and improved customer-facing activities.

It has become increasingly apparent that having a strong firmwide risk culture is one of the key components of successful risk management. As a result, there has been an intensified industry-wide effort over the past several years to proactively manage culture. Executives agree that institutionalizing a strong risk culture that creates a sense of ownership from the top ranks down to the front-line staff requires fundamental changes. Key ingredients for success must include a strong risk appetite that is embedded into business strategy and planning; clearly defined roles, responsibilities and accountability; and strong consequences for misbehavior through performance management, compensation and disciplinary actions. This year, lack of accountability in the front office was seen by more than one-third of respondents as a cause of risk culture deviating from board expectations. Firms are striving to align the sales-driven front-line staff behavior with the overall firm risk culture by strengthening accountability and implementing strong consequences for misbehavior.

The industry is facing continuing pressures on business models from regulatory changes – primarily from Basel III but also from recovery and resolution and new conduct and markets requirements. The core issue is that with the higher capital and liquidity buffers, and with investors pushing back on the resulting lower ROEs, many business lines are now no longer sufficiently profitable. Many banks have exited entire lines of business and are still exiting countries, in a continuing retreat back to core markets. Prices for banking products are also being changed, but international banks are coming under competitive pressure from local banks in some markets and shadow banks in others. The study points to continued reluctance of investors to accept lower ROEs, with almost 80% of participants reporting heightened pressure from investors to increase ROE and three-quarters reporting pressure to reduce costs.

In many other areas, the survey highlights the time and effort needed to change risk approaches and ingrain them into the enterprise. Risk appetite needs to be embedded in business decisions, but many banks still have far to go even on the traditional credit and market risks, let alone non-financial risks. Stress testing improvements occur year by year, but again, more is needed to make stress tests a flexible management tool actively influencing decisions. And despite substantial increases in investment, data and systems remain areas hampering effective change in different areas.

The six surveys to date deliver a clear picture of the industry moving steadily year by year to enhance risk governance systems and processes to meet both regulatory and market demands for tightened controls and prevent a future crisis from occurring. And while the industry has come a long way since the crisis, the journey will undoubtedly continue for some time.

Contacts

Patricia Jackson
2015 Risk management survey of major financial institutions,
lead author, and Senior Advisor Risk Governance Lead, EMEIA
London
pjackson@uk.ey.com
+44 20 7951 7564

Peter O. Davis
Financial Services Risk Management Leader, Americas
New York
peter.davis@ey.com
+1 212 773 7042

David C. Scott
Partner, Financial Services Risk Management
Hong Kong
david.scott@hk.ey.com
+852 2629 3614

Bill Schlich
Global Banking & Capital Markets Leader
Toronto
bill.schlich@ca.ey.com
+1 416 943 4554

Ian Baggs
Deputy Banking & Capital Markets Leader
London
ibaggs@uk.ey.com
+44 20 7951 2152

Mike Onak
Americas Banking & Capital Markets Leader
Charlotte
michael.onak@ey.com
+1 704 331 1827

Jan Bellens
Global Banking & Capital Markets
Emerging Markets and Asia-Pacific Leader
Singapore
jan.bellens@sg.ey.com
+65 6309 6888

Marie-Laure Delarue
EMEIA Banking & Capital Markets Leader
Paris
marie-laure.delarue@fr.ey.com
+33 1 46 93 73 21

Noboru Miura
Japan Banking & Capital Markets Leader
Tokyo
miura-nbr@shinnihon.or.jp
+81 3 3503 1115

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