REGULATIONS DRIVING SEA CHANGE IN US BANKING

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Background

With the banking crisis of 2008–09 and its associated high-profile risk management failures, increased regulatory scrutiny has significantly magnified the need for analytically skilled risk management professionals. The FDIC is now carefully scrutinizing bank compliance and sound risk management practices—particularly in the areas of interest rate risk management, commercial real estate concentrations, and funding and liquidity management. The NCUA, too, is increasing its focus on operational risk and balance sheet management in the areas of interest rate, liquidity, and concentration risk. In response to these regulatory initiatives, many financial organizations are looking for talent in these areas to expand their enterprise risk management (ERM) and analytic teams.
The purpose of this article is to provide an overview of these key regulatory initiatives driving enterprise risk management (ERM) within the US Banking market.

Consolidated Supervision Framework

The Federal Reserve (FR)'s *Consolidated Supervision Framework for Large Financial Institutions* focuses on enhancing the resiliency of large financial institutions. The framework calls for supervisory efforts to focus on four key areas:

1. **Capital and Liquidity Planning** - including:
   i. Maintenance of "processes that enable the identification and measurement of potential risks to [the] primary determinants of capital and liquidity positions";
   ii. Utilization of "comprehensive projections of the level and composition of capital and liquidity resources, supported by rigorous and regular stress testing to assess the potential impact of a broad range of expected and potentially adverse scenarios"; and
   iii. Maintenance of "sound risk measurement and modeling capabilities, supported by comprehensive data collection and analysis, independent validation, and effective governance, polices and controls".
2. **Management of Core Business Lines** – including a "strong risk-management framework that supports identification, measurement, assessment, and control of the full spectrum of risks".
3. **Effective Corporate Governance**; and
4. **Recovery Planning**

Stress Testing

Supporting the key area of Capital and Liquidity Planning, the FR has also released the *Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets*. This guidance emphasizes "the importance of stress testing as an ongoing risk management practice that supports banking organizations' forward-looking assessment of risks and better equips them to address a range of adverse outcomes". The guidance emphasizes the use of stress testing with respect to Capital and Liquidity in particular, including the evaluation of the interaction between the two areas, and the potential for both to become impaired at the same time. The guidance suggests the following stress testing approaches and applications that banks should consider using:

1. **Scenario Analysis** "in which a banking organization applies historical or hypothetical scenarios to assess the impact of various events and circumstances, including extreme ones";
2. **Sensitivity Analysis** in which the bank assesses its exposures , activities and risks when certain variables, parameters and inputs are "stressed" or "shocked";
3. **Enterprise-Wide Stress Testing** which "involves assessing the impact of certain specified scenarios on the organization as a whole, particularly with regard to capital and liquidity"; and
4. **Reverse Stress Testing** that allows a Bank "to assume a known adverse outcome… and then deduce the type of events that could lead to such an outcome".

Basel III

The U.S. continues to work towards harmonizing its regulatory capital framework with the rest of the world. In 2012, the FR released three rules to implement the Basel III regulatory capital reforms:

1. **Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios and Capital Adequacy** will apply to all depository institutions, bank holding companies (BHCs) with total consolidated assets of $0.5bn or more, and S&L holding companies.
2. **Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements** will also apply to all banking organizations. This rule will revise and harmonize the Board's rules for calculating risk-weighted assets to enhance risk sensitivity and address other identified weaknesses.
3. **Advanced Approaches Risk-Based Capital Rule & Market Risk Capital Rule** will apply to banking organizations that are subject to the advanced approaches rule or to the market risk rule. This rule will enhance risk sensitivity for internationally active firms to better address counterparty credit risk and interconnectedness among financial institutions.

Model Risk & Validation

Also supporting the key area of Capital and Liquidity Planning, and the sound risk measurement and modeling capabilities required thereof, is the FR's *Supervisory Guidance on Model Risk Management*. The guidance applies to all banking organizations and covers models used for "analyzing business strategies, informing business decisions, identifying and measuring risks, valuing exposures, instruments or positions, conducting stress testing, assessing adequacy of capital, measuring compliance with internal limits, meeting financial or regulatory reporting requirements and issuing public disclosures". Critically from a risk management professional's perspective, "all model components – inputs, processing, outputs and reports – should be subject to validation [and] this applies equally to models developed in-house and to those purchased from or developed by vendors or consultants".
With respect to model development and implementation, the guidance states that:

1. The design, theory and logic underlying the model should be well documented and generally supported by published research and sound industry practice; and
2. The model methodologies and processing components, including the mathematical specification and the numerical techniques and approximations, should be explained in detail with particular attention to limitations.

Overall, the guidance goes on to say that the quality of the process is judged by the manner in which the model is subject to critical review – and that this could be determined by "evaluating the extent and clarity of documentation, the issues identified by objective parties, and the actions taken by management to address model issues."

Interest Rate Risk

The area of Interest Rate Risk, when compared to Capital and Liquidity, has received lower levels of supervisory attention over recent years. However, two key FR releases in this area remain important:

1. **Interagency Advisory on Interest Rate Risk** – which reiterates basic principles of sound IRR management identified in the original 1996 interagency guidance, including the expectation that all institutions "manage their IRR exposures using processes and systems commensurate with their earnings and capital levels, complexity, business model, risk profile, and scope of operations"; and
2. **Questions and Answers on Interagency Advisory on Interest Rate Risk Management (Q&A)**, that provides interpretive guidance in relation to a number of issues including:

    i. Appropriateness of vendor models;
    ii. Assessing the impact of new strategies on IRR management capabilities; and
    iii. Internal controls and validation – including validations provided by vendors.

Next Steps

Regardless of our title or role, it is imperative we keep learning and keep developing as leaders. Because the world is changing so fast, we must be agile, proactive learners. The new risk management environment is a wake-up call for many of us who have stayed under the radar the past few years. It is time to do career reconciliation: how did we get to where we are now, what is going on in the external environment and our organization, what is possible with the current trajectory of the intersection of the external environment with our organization, and how do we want to be in this trajectory are provocative career questions.

If someone asked us these questions today, what would be our answer? What is our unique value proposition in our life, both personally and professionally, and how do we sustain our value to self and others?