BANK NEWS

Mazars banking newsletter / N°14

SPECIAL ISSUE :
BANKING SUPERVISION

Emmanuel Dooseman
Partner, Global co-Head
of Banking at Mazars

EDITORIAL

Depending on the countries and currency areas concerned, central banks may be asked to fight inflation (and sometimes unemployment) and to encourage growth, but they are also required to monitor the resilience of the banking system through the supervision and control of solvency and liquidity. They therefore have the dual responsibility of implementing monetary policy and of supervising banking systems.

Since the second half of 2007 they have been very active on both fronts. They have conducted expansionary monetary policies, described today as 'non-standard' policies, but have also been engaged in a comprehensive revision of the rules for banking regulation and oversight.

Central banks play a more essential role than ever in a lacklustre economic landscape where fiscal policies are under constraint. The choices they make and implement today will determine the development of our financial systems.

The adjustments introduced by the Basel Committee and national and international regulators in Africa, Asia, America and Europe, the avalanche of regulation, the introduction of new ratios (liquidity, TLAC) and the enhancement of other indicators (solvency, leverage) are bringing about radical change in our banking systems. These measures are fostering the emergence of new players engaging in the activities abandoned by the banks who now find them prohibited, or too costly.

The desire to prevent, or more realistically to curtail, the risk of bank failures and to restore the confidence of economic actors is having a profound long-term impact on the business model of banks. But in doing so, these regulatory developments are also changing the supervisory practices of central banks, as is the impact of injections of liquidity, the central bankers' essential tool for monetary policy.

These developments pose challenges to regulators, supervisory authorities and the banking sector against a background of historically weak rates that call into question our practices and paradigms.

Enjoy your reading!

CONTENTS

P.2 I THE BANKING INDUSTRY TRACKER

P.3 I SPECIAL REPORT : HOT TOPICS IN BANKING SUPERVISION WORLDWIDE

P.9 I ANALYSIS : THE ECB'S INTERVENTION AND BANK LIQUIDITY

P.15 I MAZARS INSIGHT: RISK CULTURE AND SUPERVISION - BEYOND THE BOX-TICKING EXERCISE, STRIVING FOR FAIR BALANCE.

MAZARS

THE BANKING INDUSTRY TRACKER

PERFORMANCE OF THE MAIN EUROPEAN BANKING GROUPS

31.12.2014 (Mds €)	Total Assets		Operating Income		Risk-Weighted Assets		Credit risk		Cost-income ratio		Core Tier 1 Ratio	
HSBC	2169.6 ↓	-1%	56.1 →	0%	1004.7 →	0%	2.9 ↓	-34%	67% ↑	13%	11% →	1%
BNPP	2077.8 ↑	15%	39.2 ↑	5%	619.8 ↓	-1%	3.7 ↓	-9%	70% ↑	4%	10% →	0%
Deutsche Bank	1709.0 ↑	6%	31.9 →	0%	394.0 ↑	13%	1.1 ↓	-45%	87% ↓	-3%	12% ↓	-9%
Crédit Agricole	1589.1 ↑	5%	15.9 ↑	1%	293.0 ↓	-2%	2.2 ↓	-24%	70% ↑	11%	13% ↑	17%
Barclays	1744.4 ↑	1%	31.4 ↓	-9%	516.0 ↓	-9%	2.7 ↓	-29%	81% ↑	3%	10% ↑	13%
Société Générale	1308.2 ↑	8%	23.7 ↑	6%	353.2 ↑	3%	3.0 ↓	-27%	68% ↑	1%	10% ↑	1%
RBS	1349.0 ↑	2%	18.8 ↓	-9%	457.1 ↓	-17%	-1.7 ↓	-117%	68% ↓	-6%	11% ↑	30%
Santander	1266.3 ↑	13%	42.6 ↑	7%	583.2 ↑	19%	10.7 ↓	-5%	49% ↓	-5%	10% ↓	-17%
BPCE	1223.3 ↑	9%	23.6 ↑	2%	393.0 ↓	-4%	1.8 ↓	-13%	69% ↓	-1%	12% ↑	15%
Moyenne	1149.1 ↑	5%	23.7 →	0%	372.9 →	0%	2.4 ↓	-37%	67% ↑	2%	12% ↑	5%
Lloyds TSB	1097.6 ↑	1%	22.8 ↓	-2%	307.7 ↓	-12%	0.9 ↓	-73%	51% ↓	-3%	13% ↑	24%
ING	992.9 ↓	-8%	15.6 ↑	2%	296.0 ↑	5%	1.6 ↓	-30%	59% ↑	3%	11% ↑	14%
Unicredit	844.2 ↑	2%	21.3 ↓	-8%	409.2 ↓	-3%	10.7 ↓	-21%	62% →	1%	10% ↑	7%
UBS	883.6 ↑	5%	23.1 ↑	1%	180.0 ↓	-4%	0.1 ↑	56%	91% ↑	3%	13% ↑	5%
Crédit Suisse	766.4 ↑	6%	21.6 ↑	1%	242.4 ↑	6%	0.2 ↑	11%	87% ↑	2%	15% ↓	-5%
Crédit Mutuel	706.7 ↑	7%	15.4 →	1%	232.8 ↑	11%	0.1 ↑	15%	64% ↑	1%	16% ↑	9%
Nordea	669.3 ↑	6%	10.2 ↑	3%	145.4 ↓	-6%	0.5 ↓	-27%	49% ↓	-4%	16% ↑	5%
BBVA	631.9 ↑	8%	20.7 →	0%	350.8 ↑	8%	4.3 ↓	-23%	51% ↓	-2%	12% ↑	3%
Commerzbank	557.6 ↑	1%	9.3 →	0%	215.2 ↑	13%	1.1 ↓	-35%	79% ↑	8%	12% ↓	-11%
KBC	245.2 ↑	3%	6.7 ↓	-10%	91.2 →	0%	0.5 ↓	-74%	57% ↑	10%	14% ↑	12%

ASIA: BALANCING CREDIT RISKS

BY ANNIE CHAN, PARTNER AT MAZARS HONG KONG

Asia has experienced rapid growth in bank loans and credit since the global financial crisis in 2008. Capital inflows have been seen as a catalyst of growth for Asia. In accordance with the Asian Development Outlook 2015 issued by the Asian Development Bank, proliferating bank loans and bonds in 14 large developing economies of Asia almost doubled total domestic debt from USD18.3 trillion to USD34.1 trillion during the year 2003 to 2013. A large portion of growth in debts comes from rapid credit expansion in China, which accounted for two-thirds of the total debts in 2013. Most of the new debts are in the private sector. In particular, household debt and non-secured credit card debt have been growing exceptionally fast.

Regulators are trying to manage credit expansion and excessive leverage to minimize the impact of asset price bubbles.

Even though the US Federal Reserve is planning to raise the US interest rates, central banks in Asia are loosening monetary policies in order to stabilize their economies. They are exploring new ways to reduce the cost of credit to stimulate local investment and spending in their domestic economies.

For example, the central bank in China (the People's Bank of China) has cut its interest rate twice in the past few months and has injected short-term funds into the banks, further reducing borrowing costs and extending credit for Chinese businesses. Based on the information released by the People's Bank of China in February 2015, the stock of total social financing (TSF) was RMB123 trillion as of the end of 2014, an increase of 14.3% as compared to 2013.

SOUND AND EFFECTIVE BANKING REGULATION AND SYSTEMS ARE VITAL TO MAINTAINING FINANCIAL STABILITY IN ASIA.

Although credit expansion supports economic growth in most Asian countries, these developments have raised a number of issues and created risks in the banking system, potentially creating excessive leverage and financial bubbles. Some countries like Indonesia, China, Hong Kong, Macau and Sri Lanka are experiencing the highest macro-prudential index (MPI) across the region, indicating a potential risk in the banking system due to rapid credit growth associated with the risk of financial bubbles.

THE WAY FORWARD

Sound and effective banking regulation and systems are vital to maintaining financial stability in Asia. Bankers and policy makers are taking steps in strengthening the requirements in risk management systems and practices to manage and mitigate systemic risks in the banking sector.

To accurately assess the financial position of individual or corporate borrowers, bankers are encouraged to:

- Enhance their “know-your-client” and “customer due diligence” procedures by obtaining additional information (such as employment history, acceptable credit record, asset requirement, acceptable age range, residence type, etc.) from customers before loans are granted.

- Set up clear and comprehensive guidelines for handling applications from customers who do not have a stable source of income, including how the repayment ability of these customers should be assessed and what credit limit should be set.

- Check the customer credit data through a credit reference agency.

- Establish policies and procedures to deal with customers who have genuine difficulties in repaying their loans. Workouts or realistic solution for repayment can be considered.

- Perform on-going reviews on customers’ financial positions regularly.

A sound and robust financial system can definitely help sustain Asia’s economic growth.

SPECIAL REPORT: HOT TOPICS IN BANKING SUPERVISION WORLDWIDE

EUROPE: LOOKING AHEAD - ECB AND NCA FOCUS 2016, AND WHAT DOES IT MEAN FOR THE MARKET PARTICIPANTS?

BY MARK KENNEDY, PARTNER AT MAZARS IRELAND

ONE HEARS MORE AND MORE TALK OF A ANOTHER ASSESSMENT IN 2016, OF NATIONAL CENTRAL BANKS EXTENDING THE NET (AQR-LITE) TO NON-SYSTEMIC BANKS, AND IN SOME JURISDICTIONS EVEN AN EXTENSION OF FOCUS TO THE STRENGTH OF THE INSURANCE SECTOR.

The last five years have been a time of much challenge and change for the Central Banking Fraternity in Europe. Crisis, both economic and political, has been followed by much adjustment and change, including both practical economic and policy interventions, structural change in the form of Banking Union, much new regulation and most recently the adoption of QE, Draghi style. Much has been done, but the agenda remains long. As we pass the midway point of 2015, it is perhaps useful to reflect on what may be to the fore in the coming year.

Three things will, I believe, drive the activity of the ECB and it's national constituents. First, the ongoing economic sluggishness in Europe overall. Interestingly, it seems likely that some tensions will become to emerge, with those economies performing more strongly likely to wish to see some easing of ECB supports, while the weaker economies will probably lean towards a longer period of ECB actions. My guess is that the overall scenario will remain sufficiently uncertain that the ECB will hold its position for much of 2016 - we are a long way from the danger zone as regards inflation. This means different things for our clients - investors will continue to hunt for elusive yield, while others will use the opportunity to continue to build and rebuild balance sheets. In the banking and insurance sectors this, combined with ongoing changes to the capital regime driven by regulatory requirements, may see a hotting up of competition for tier 1 capital. It will also mean that some of the remaining challenges in investment and loan books will be assessed (in some cases for the first time), which will perhaps mean that the issue of NPL's and valuation of portfolios re-emerges.

The second area of focus is firmly in the area of supervision. The 2014 comprehensive assessment tested only 50% of all European bank balance sheets. One hears more and more talk of a another assessment in 2016, of national central banks extending the net (AQR-lite) to non-systemic banks, and in some jurisdictions even an extension of focus to the strength of the insurance sector. This comes at a time where banks (and regulators) are struggling to cope with new regulatory and quasi-regulatory requirements -

for example, we are not far from full implementation of Basel 3/CRDIV/IFRS9/BRRD and in the insurance sector Solvency 2, to name but a few of the items on the desk at present. This means the allocation of very significant resource in the next eighteen months, both in regulator teams and in the banks and insurance companies. As I have already noted, the underlying condition of bank balance sheets will be tested by these developments - with each of these requirements re-evaluating our collective understanding of the position of many financial institutions.

The last area worth mentioning is that of politics and policy. There is a significant amount of work to be done to implement BRRD, and this will test the resolve of the European authorities - hard cases will prove the worth of the new framework. Also, the proposals of the Green Paper on Capital Markets are potentially very significant and will be a point of attention for a number of years. In many jurisdictions there will be strong local pressure to ensure that a benign view is taken of the strength of some institutions. I would add that the mandate of the ECB is not at all political - in fact, the specific exclusion of a role in relation to employment benchmarks renders the ECB and NCA's outside one significant area of potential political influence. Nonetheless, I believe that there will be some pressure on Central bankers to find an acceptable (to the politicians) view in the course of assessing balance sheet strengths of individual banks.

Finally, it is worth reflecting that the European Crisis has been characterised by ECB positioning in spite of (or perhaps because of) a lack of decisive political progress. As we look at the situation in mid-2015 one is conscious the delicacy of the Greek and UK positions, and might be forgiven for wondering what actions the ECB may have to consider before too long.

SPECIAL REPORT: HOT TOPICS IN BANKING SUPERVISION WORLDWIDE

AFRICA: OVERVIEW OF BANKING REFORMS IN FRENCH-SPEAKING COUNTRIES

BY ZIED LOUKIL, LOCAL PARTNER AT MAZARS TUNISIA / AFRICAN BANKING PLATFORM

In recent decades, the African banking sector has seen significant changes, and has witnessed the appearance of pan-African banking groups under the impetus of strong economic growth and the creation of regional markets.

Certainly, African banks have by and large been spared by the subprime financial crisis, due to their weak exposure to the international financial system. However, major reforms in regulation and banking supervision have been introduced in recent years, at a rate and on a scale that differs from one country or monetary area to another.

These reforms aim to strengthen the resilience of the banks and their supervision while taking account of changes in the African banking landscape and the emergence of new risks. This drive towards reform shows signs of gradual convergence with international standards, suggesting a desire for greater integration with the global economy.

In North Africa, the supervisory authorities have in recent years adopted banking reforms to strengthen supervision and the oversight of risks.

In Morocco, a new banking law was adopted in November 2014 strengthening the oversight and regulatory powers of the Moroccan central bank (Bank Al-Maghrib), modernising macro-prudential measures and introducing a legislative framework to regulate the activities of participating banks (Islamic finance).

Morocco is also pursuing the gradual implementation of Basel III prudential standards.

A draft law currently under finalisation aims to strengthen the independence of the Bank Al-Maghrib and to extend its oversight mandate. Note that the Bank Al-Maghrib closely monitors the development of Moroccan banks in the African markets, in particular by strengthening cross-border supervision in collaboration with the competent authorities in host countries.

In Algeria, new measures have been introduced to strengthen the prudential rules applicable to banks (solvency ratio, risk diversification ratios, classification and provisioning of loans and liabilities, etc.). These reforms also aim to restore the health of the Algerian banking sector following the difficulties encountered in the early part of the century.

Laws on the prevention of money laundering and the funding of terrorism have been updated to strengthen existing measures and to boost the preventive efforts of Algerian banks.

In Tunisia, the main developments in terms of oversight relate to the introduction of a standard system for reporting the results of banks and the creation of an internal system for analysis and rating within the Central Bank of Tunisia. From a prudential perspective, a new 'forward-looking' liquidity ratio including off-balance sheet transactions has applied since January 2015 (minimum ratio of 60% raised by annual 10% increments to reach 100% in 2019). This ratio will be supplemented by qualitative requirements in line with international practices.

The process of restructuring Tunisian public banks is also continuing. After finalisation of the "Full Audit" exercise, the next stage will consist of implementing the plans for restructuring and recapitalisation. Finally, a draft banking law is currently in the course of finalisation. The main expected outcomes include the implementation of a mechanism for restructuring and resolution and the introduction of a legislative framework for Islamic banks.

In West Africa the Central Bank of West African States (BCEAO) has already begun work on a revision of the banking chart of account (PCB) of the West African Monetary Union (WAEMU). This reform aims to adjust accounting standards to reflect the changes in the transactions handled by banks in the region and to take account of international accounting principles (IFRSs) and Basel prudential rules (supervision on a consolidated basis, the third pillar 3 of Basel II on market discipline, etc.).

Other notable developments include the recent reform of the West African accounting standards (SYSCOA) applicable to trading and industrial companies, which are converging towards international accounting principles. The revised SYSCOA, effective from 1 January 2015, will improve the quality of accounting information and promote financial transparency throughout the region. This in turn will improve credit risk management in the banking system.

In central Africa, several reform projects are currently under study. The most important of these relates to the requirement for credit institutions, micro-finance institutions and financial holding companies to present their consolidated financial statements under IFRSs. This proposed reform, the effective date of which is not yet certain, is sure to have a significant impact on preparers of financial statements and will improve the quality and reliability of the financial information published.

Other reforms are expected in order to introduce prudential standards and supervision on a consolidated basis, and to strengthen cross-border supervision. The recent increase in human resources at the Banking Commission of Central Africa (COBAC), accompanied by appropriate training measures, should enable it to improve oversight of the financial sector throughout the region.

All these reforms and projects in progress will without doubt contribute to better banking supervision and more fitting risk management. The banking sector in French-speaking Africa remains vulnerable to significant risks which vary from one country to another. This will require further and accelerated reform, particularly in terms of introducing consolidated and strengthened oversight of cross-border banking groups. This oversight should be risk-based (credit registers, rating systems, prudential ratios, forward analysis, etc.) and will require an increase in the human and financial resources of the supervisory authorities.

Some countries also have urgent need of other major reforms, such as the introduction of banking resolution mechanisms, the creation of deposit guarantee schemes and stronger supervision of a number of financial activities which have begun to expand (micro-finance, for example).

The implementation of these reforms will safeguard the solvency of African banks and hence guarantee financial stability and sustainable economic development.

ANALYSIS

Jean-Baptiste BELLON
Trapeza Conseil

TRAPEZA
perspectives financières

Trapeza is an independent consultancy and research firm specialising in the banking sector. Trapeza's role is to advise and assist banking professionals and investors on performance measurement. The analysis draws on several tools used on the financial markets, and brings together accounting, financial and strategic data.

THE ECB'S INTERVENTION AND BANK LIQUIDITY

BY TRAPEZA CONSEIL

A massive injection of liquidity has been the answer of central banks and the ECB to the crisis and the financial market dislocations that followed the failure of Lehman Brothers in September 2008. The authorities have followed, though not always consistently, the traditional recommendations to close insolvent banks and support the rest [1]. This entails the provision of liquidity at attractive rates to those banks whose economic models are sustainable. A number of economic models have collapsed in the disorder of the financial crisis, primarily those which were founded on too-narrow a deposit basis (resort to market financing), on excessive levels of transformation (long-term credit, short-term funding), on high operational leverage (volume growth), or on all three at once. But other economic models have proved relatively resilient in the face of the crisis.

Against this background, the prudential authorities have forced the banks to consolidate their financial structure by significantly increasing their capital and reserves. This is due to the formal introduction in Basel III of a 'core' capital ratio, CET 1, with a minimum level of 7%, compared with an accepted range of 2% to 4% under Basel II. This level has since stalled at a level between 9% and 12%, depending on the conflicting demands of investors and regulators. The major European banks therefore almost doubled their capital and reserves between 2007 and 2014, while the size of their balance sheets has grown only modestly. But this growth in capital levels has been accompanied by an equally profound change in the financial structure of the banks: a drastic reduction in the use of short-term debt and banking activity in the short-term liquidity markets (interbank markets, trading and repurchase agreements, etc.). This development has been observed by numerous commentators, but a recent analysis has introduced an interesting angle by using the traditional concepts for analysing the financial structure of a business [2].

The difference between long and medium-term resources (including capital) and fixed assets represents working capital (the gap between current assets and current debts). The banks have few tangible assets on their balance sheets, while the amount of capital and reserves is determined by regulation. This structure is quite similar to that of non-financial entities, since these must obtain their working capital by maintaining a surplus of medium-term resources over fixed assets. Of course the comparison with other

1 W Bagehot, *Lombard Street* 1885.
2 Vivien Levy-Garboua: *Petite explication du* "deleveraging", Agefi Hebdo of 28 May 2015.

business can only be taken so far, since a significant proportion of the banks' long-term assets are held in reserves of credit and securities, particularly when market liquidity is dwindling. Nonetheless, retaining this definition, working capital has increased over the period in step with the consolidation of capital, and the evolution of the BNP Paribas balance sheet provides a good illustration.

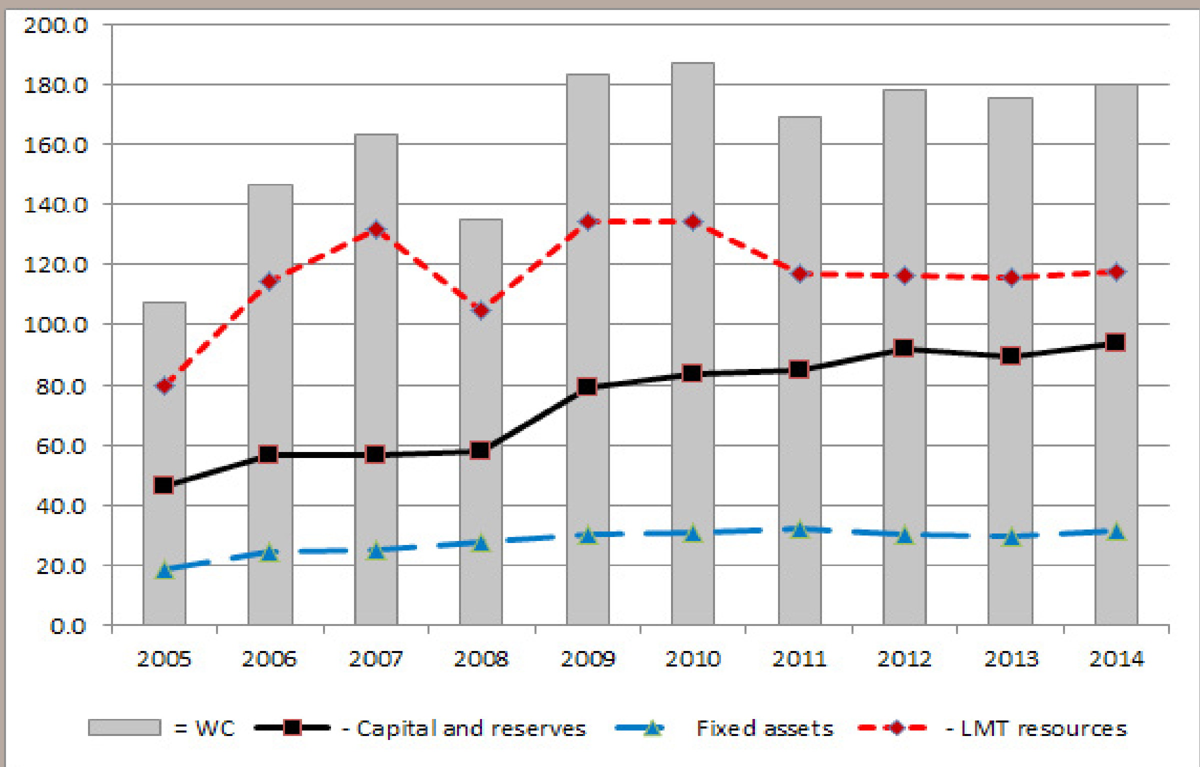
An analysis of working capital requirement can also be coupled with this analysis of working capital. In terms of this analysis, this is defined as total banking activity assets, i.e. net trading positions, share portfolios (financial and other investments) and loans, from which are deducted customer resources, represented by deposits and insurance funds. Applied to BNPP, the WCR calculation reveals three periods:

- a sharp increase between 2005 and 2007, linked to the strong growth in net trading positions

- stability between 2007 and 2011, after a steep fall in trading in 2008 which continued but which was offset by the rise in other securities portfolios

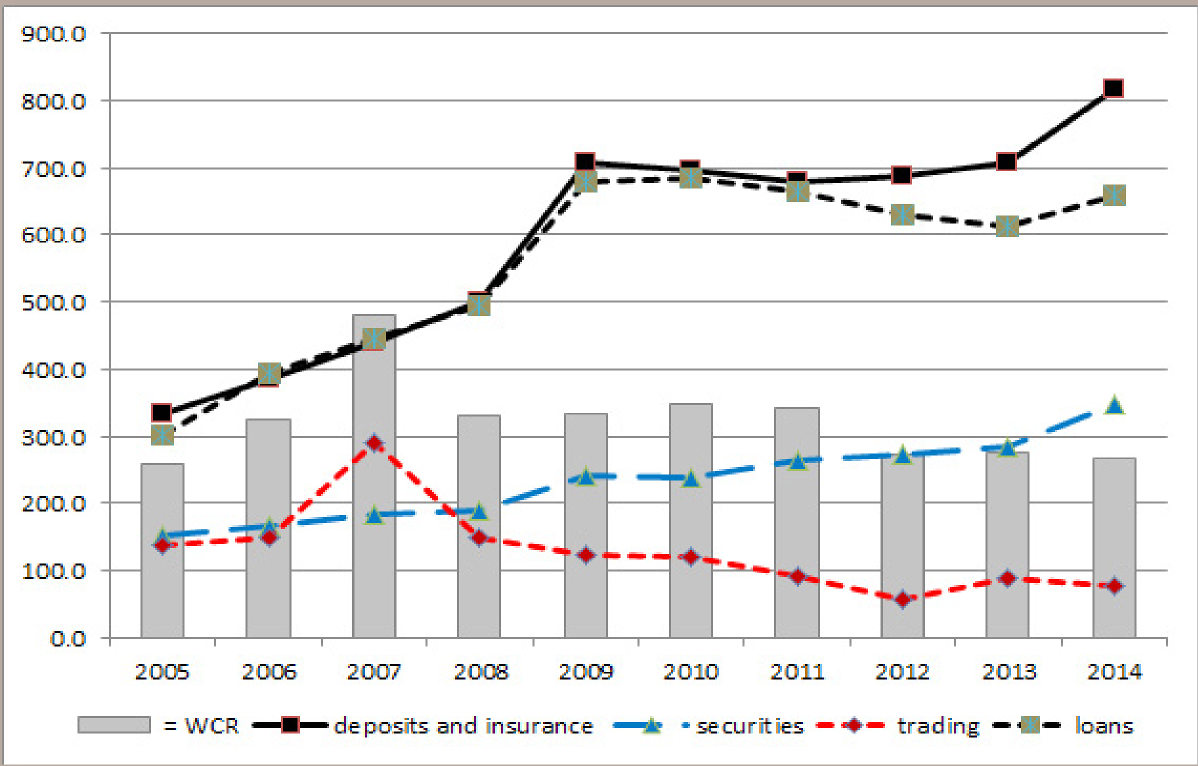
- a fall in the WCR in 2012, followed by a slight reduction, due to the surplus of deposits and insurance over loans, in part used to finance an increase in securities portfolios.

EVOLUTION OF BNP PARIBAS WORKING CAPITAL



Source: BNPP annual reports and Trapeza Conseil calculations.

EVOLUTION OF BNP PARIBAS WORKING CAPITAL REQUIREMENT



Source: BNPP annual reports and Trapeza Conseil calculations.

As in any business, the difference between working capital and the working capital requirement is debt or net cash. This passed from over €200 bn at the start of the period to less than €100 bn at its end. This represents a significant decline in the bank's recourse to the financial markets.

This analysis is fairly close to the banks' own presentation of their financial structure in their annual statements. To provide a more accurate reading of their financial structure, French banks began in 2010 to publish 'financed balance sheets', which only apply to banking activities (deconsolidation of the insurance business).

This is because banking activities have a different impact on the balance sheet depending on whether the assets and operating resources involve financing (loans, securities, deposits, etc.) or whether it is simply a matter of measuring financial instruments at their market value (derivatives) without any financing flows. Furthermore, under IFRS accounting conventions some balance sheet items are not offset (repo operations, derivatives, etc.).

FINANCED BALANCE SHEET OF FRENCH BANKS IN 2014

2014 data	G4 €Bn	G4	BNPP	BPCE	CASA	SocGen
			Financed balance sheet data in % of total			
Liquidities and BC	290	8	11	9	6	8
Interbank	110	3	3	3	2	5
Trading	235	7	8	4	4	13
Securities	431	12	14	9	14	11
Loans	2224	64	59	73	69	57
Other assets	159	5	5	3	5	6
Financed balanced sheet	**3449**	**100**	**100**	**100**	**100**	**100**
Short-term borrowings	483	14	15	17	12	13
Deposits	2071	60	61	58	62	58
Other liabilities	20	1	0	0	0	3
Medium & long-term borrowings	558	16	15	17	17	17
Equity	317	9	9	8	10	9
Consolidated balance sheet	6207	180	193	175	155	202
Insurance balance sheet	619	18	16	8	28	16
Banking balance sheet	5588	162	177	167	128	186
- difference	2139	62	77	67	28	86

Source: annual bank reports and Trapeza Conseil calculations

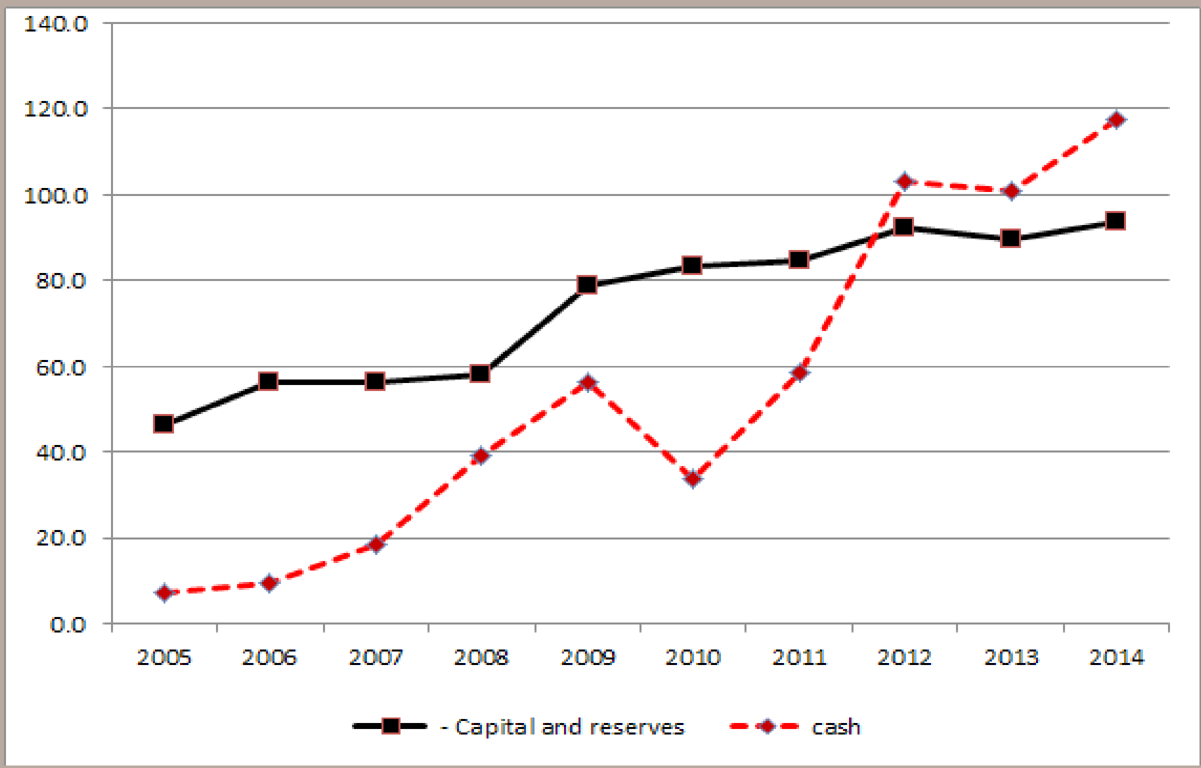
The financed balance sheets (that is, excluding insurance activities) of the four French groups show:

- the decisive weight of conventional banking activities, loans and deposits representing almost 2/3rds of the balance sheet total

- the limited impact of trading activities, averaging at 7% with significant differences between banks, accompanied by the constitution of a securities, liquidity and investment portfolio representing 12% of the total

- and finally the very significant weight of liquidities (8% of the balance sheet) in relation to short-term debts (14%). These have remained high because of the constitution of reserves of cash and deposits with the central banks to safeguard the banks against the adverse consequences of possible liquidity crises.

EVOLUTION OF BNPP CASH AND CAPITAL AND RESERVES

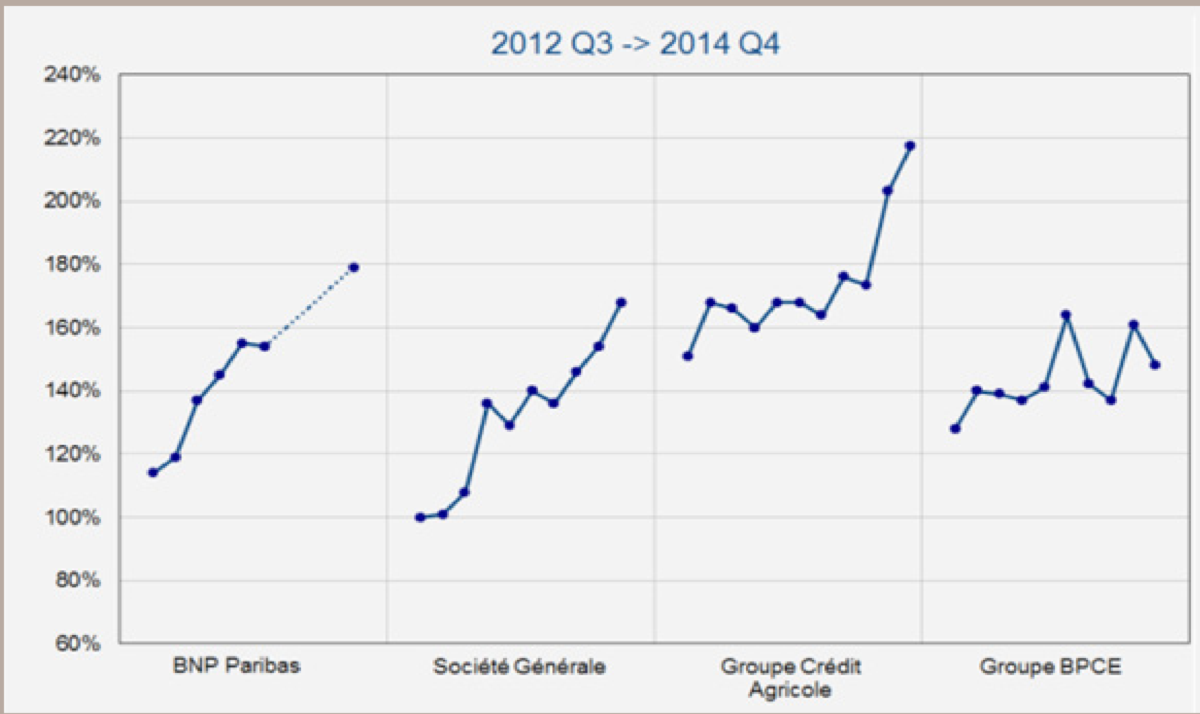


Source: BNPP annual reports and Trapeza Conseil calculations

Since 2011 the banks have also modified their financial structure to prepare for the introduction of the Liquidity Coverage Ratio (LCR). As the EBA notes in its progress report on the introduction of liquidity measures in Europe [3], the banks have at once reduced a source of vulnerability in the event of stress (less use of financing due within one month) and significantly increased their stocks of high-quality liquid assets (HQLA). This observation is certainly true of the French banks. Cash increased more than capital and reserves and as the example of BNPP - a good illustration of developments in the banking sector - shows, from 2012 onwards cash may exceed capital and reserves.

3 EBA : *second report on impact assessment for liquidity measures*, 23 December 2014

LIQUID ASSETS AS A % OF SHORT-TERM DEBTS OF FRENCH BANKS

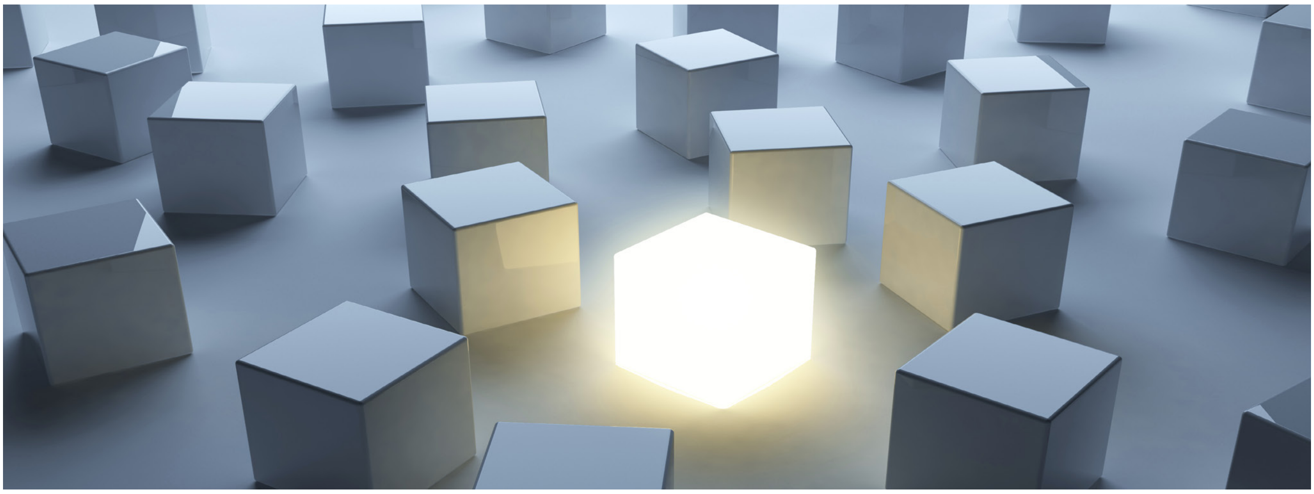


Source : Haut Conseil de Stabilité Financière (HCSF), rapport annuel 2015, graphique n°36

As can be seen from the analysis published by France's Financial Stability Council (the Haut Conseil de Stabilité Financière) in its 2015 report, the total liquid assets of French banks in the broad sense, meaning cash plus securities that are negotiable in a liquid market, substantially exceed the level of use of short-term financing.

This is partly explained by the desire to reach a LCR (short-term liquidity) level above 100% by the end of 2014, something which has been achieved by the four French groups. In terms of the result this increase in the balance sheet weight of liquidity entails an additional cost corresponding to the cost of carry of this portfolio. Conservative assumptions suggest that this extra cost can be estimated at 5% of the operating result of French banks, which stood at €32 bn in 2014 for the six groups monitored by the French supervisory authority, ACPR.

However, this may not be the most significant adverse impact. While the banks have increased the weight of liquid assets in their balance sheets, they are stockpiling them, hoarding them on the balance sheet so that they no longer sustain the securities markets whatever their quality to the same extent. In terms of the operation of markets, this causes an increase in episodes of volatility which the massive intervention of the ECB is insufficient to overcome.



RISK CULTURE AND SUPERVISION: BEYOND THE BOX-TICKING EXERCISE, STRIVING FOR FAIR BALANCE

BY GREGORY MARCHAT, PARTNER AT MAZARS UK

RISK CULTURE: A HIGH PRIORITY ON THE REGULATORS' AGENDA

Since the 2008 crisis, the financial sector has been under scrutiny. Identified as one of the crisis root causes, the importance of risk management framework and risk culture and its interconnectedness to ensure the long run financial stability of each organisation has been revealed. Accordingly, institutions are expected to develop an effective risk management framework and a sound risk culture.

The increasing focus on these topics as well as their relevance for regulators at global level are testified in the Financial Stability Board (FSB) consultative document: Guidance on Supervisory Interaction with Financial Institutions on Risk culture: A Framework for Assessing Risk culture, issued in November 2013. According to this paper "An anticipatory and strategic approach to supervision rests, among other things, on the ability to engage in high-level sceptical conversations with the board and senior management on the financial institution's risk appetite framework, and whether the institution's risk culture supports adherence to the board-approved risk appetite."

RISK MANAGEMENT FRAMEWORK AND RISK CULTURE: THE VIRTUOUS CIRCLE

The risk management framework is the combination of elements that encourage and maintain risk management throughout an organisation. It includes risk management policies, objectives, commitments and organisational arrangements (plans, accountabilities, processes and tools).

Risk culture, on the other hand, is the set of norms and behaviours that determine the way in which individuals and groups identify, understand, discuss and act on risks. By influencing actions and decisions, risk culture is a powerful driver to support the implementation of a robust risk management framework.

A sound risk culture does not only provide financial institution staff with guidance for their own behaviour, but it also encourages them to challenge and be part of the risk management decision-making process. Implementing an effective risk management framework requires a sound risk culture, which ultimately benefits from a robust risk management framework, thus triggering a virtuous circle.

RISK CULTURE SUPERVISION: AVOIDING THE BOX-TICKING TRAP

Risk culture is not a quantitative or tangible element that can easily be assessed and quickly implemented. It is a behavioural concept. Developing and communicating a sound risk culture requires time and methodology as recognised by the Institute of International Finance (IIF): "Good risk culture is easy to articulate, hard to execute and requires ongoing attention, even when the starting point is acceptable. Cultural change programs are extensive and require persistence over significant time to be successful" .Capitalising on a common base of successful practices, behaviours and attitudes which already exists might be an option. However, adopting a tailored approach to each institution's organisation and complexity is the most appropriate way to ensure successful risk culture embeddedness.

Regulatory bodies have taken up this challenge and started building guidance to supervise risk culture. The consultative document issued by FSB in November 2013 exposes a list of four indicators that can provide evidence on the soundness of a risk culture: tone from the top, accountability, effective communication and challenge, and incentives. However, it is specified that this is a non-exhaustive list, and that there are several indicators or practices that can be indicative of a sound risk culture.

Based on the different recommendations and practical examples introduced in the guidance, supervisors or commissioned independent advisors are now able to identify areas for improvement related to risk culture and respectively ask for or suggest corrective actions.

However, can risk culture or any culture at all be captioned through a prescriptive framework? This is one of the issues raised by the Institute of International Finance (IIF) along with the Global Financial Markets Association (GFMA), in their response to the FSB Guidance.

IIF and GFMA commented that the risk culture indicators might tend to be prescriptive, reducing the flexibility required by risk culture assessment. Risk culture is not a static object. It evolves according to each financial institution's specificities including its economic environment. A less compliance-driven and more flexible framework to assess risk culture practices may encourage financial institutions to define and promote their own risk culture.

ADOPTING A 360° STYLE TO MANAGE RISK CULTURE

Risk culture is a nascent field from a regulatory point of view and best practices are constantly emerging to address it. The IIF-GFMA response suggests for instance that the tone from the top indicator is important but not sufficient to ensure a sound risk culture. Tone at the middle should be emphasised because the middle management usually transmit the day-to-day messages and expected behaviours agreed at top management level. Compensation practices are also a powerful driver for developing a robust risk culture. Finding the fine balance between sanction and reward while focusing on good behaviours might be worth exploring. The IIF legitimately stresses that "Ultimately, the essence of risk culture is that it is motivated not really by awards or fear of consequences, but by internalization of an organisation's values such that individuals naturally align themselves with those values". However, it should be mentioned that proposing enough incentives for good behaviour in the present should not prevent financial institutions for implementing and developing a sound risk culture in depth in the long run.

ENHANCING RISK CULTURE SUPERVISION, A COLLABORATIVE APPROACH

Supervisors and business advisors benefit from a unique point-of-view through their reviews of risk culture in the financial sector. Their insight could be precious for building a culture assessment guidance that could reconcile business needs and specificities as well as supervisors' expectations. Publishing more case studies and best risk culture practices across the financial services industry could be very helpful for organisations to grasp more precisely how to practically improve their risk culture.

Financial institutions experience on the front line the necessity of a sound risk culture and its operational implications. They should be more actively involved in that area and invited to share their experience through the development of a collaborative relationship with their own regulators.

A collaborative approach among regulators, business advisors and financial institutions could be a key factor in ensuring organisations are able to develop and communicate a sound risk culture.

CONCLUSION

Risk culture is not just a concept but rather a challenge that the financial sector as a whole must face in the years to come.

The UK is an interesting example, in terms of its awareness and supervision of risk culture in the financial sector.

Regulation in Britain is organised around two complementary and inseparable authorities:

• the Prudential Regulation Authority (PRA) responsible for prudential regulation in the financial sector; and

• the Financial Conduct Authority (FCA), charged with supervision of the conduct of trading activities and ensuring the integrity and transparency of the financial markets.

In terms of supervision of risk culture, what emerges from the British example is:

• their unusual organisation, which enables them to approach banking oversight from prudential and business angles, addressing both quantitative and non-quantitative aspects;

• their capacity to prioritise and act proactively, working in concert despite the different scope and mandate of the FCA and the PRA. In its Business Plan & Risk Outlook 2015 the FCA identified the deficiencies in terms of risk culture and controls as one of the four priority areas in 2015. For its part, the PRA has already started to conduct reviews in this area and is in the process of considering how to quantify the impacts of weak risk management and inadequate governance. In the text CP1/15 published in January 2015, the PRA proposes to ask the Bank concerned to increase its capital in order to create a buffer against the risk caused by this situation until such a time as it is completely resolved. Although this document makes no explicit mention of risk culture, it seems clear that it will be affected by these changes because of its essential role in establishing a solid and sustainable framework for the management of risk.

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CONTACT US

Mazars Global Banking Practice

Emmanuel DOOSEMAN
Partner
Tel. : +33 (0)1 49 97 66 93
E-mail: emmanuel.dooseman@mazars.fr

Rudi LANG
Partner
Tel. : +44 (0)207 063 4440
E-mail: rudi.lang@mazars.co.uk

BANK NEWS

Charles DE BOISRIOU
Partner, Global Head of Financial Services
Tel. : +33 (0)1 49 97 64 75
E-mail: charles.de.boisriou@mazars.fr

ALGERIA
Samir HADJ ALI
samir.hadj-ali@mazars.dz

ANGOLA
Jacques DOS SANTOS
jacquesdossantos@mazars.pt

AUSTRIA
Peter ERNST
peter.ernst@mazars.at

BELGIUM
Dirk STRAGIER
dirk.stragier@mazars.be

BENIN
Armand FANDOHAN
armand.fandohan@mazars.ci

CAMEROON & CONGO
Jules-Alain NJALL BIKOK
janjall@mazars.cm

CHINA
Julie LAULUSA
julie.laulusa@mazars.cn

CZECH REPUBLIC
Milan PROKOPIUS
milan.prokopius@mazars.cz

EGYPT
Mohamed EL MOETAZ
elmoetaz@mazars.com.eg

FRANCE
Charles DE BOISRIOU
charles.de.boisriou@mazars.fr

GERMANY
Stefan LUTZ
stefan.lutz@mazars.de

GHANA
Ernest AKONOR
ernest.akonor@mazars.com.gh

HONG KONG
Annie Chan
annie.chan@mazars.hk

HUNGARY
Philippe MICHALAK
philippe.michalak@mazars.hu

INDIA
Viraf MEHTA
viraf.mehta@mazars.in

IRELAND
Mark KENNEDY
mkennedy@mazars.ie

ITALY
Olivier ROMBAUT
olivier.rombaut@mazars.it

IVORY COAST
Armand FANDOHAN
armand.fandohan@mazars.ci

JAPAN
Emmanuel THIERRY
emmanuel.thierry@mazars.jp

JERSEY
Jason LEES-BAKER
jason.lees-baker@mazars.je

LEBANON
Jacques SAADE
jacques.saade@mazars.com.lb

LUXEMBOURG
Muhammad HOSSEN
m.hossen@mazars.lu

MADAGASCAR
David RABENORO
david.rabenoro@mazars.mg

MAURITIUS
Sudhir SESUNGKUR
sudhir.sesungkur@mazars.mu

MOROCCO
Kamal MOKDAD
kamal.mokdad@mazars.ma

THE NETHERLANDS
Kees HARTEVELD
kees.harteveld@mazars.nl

NIGERIA
Olumuyiwa COKER
olumuyiwa.coker@mazars.ng

POLAND
Olivier DEGAND
o.degand@mazars.pl

PORTUGAL
Fernando VIEIRA
fernandovieira@mazars.pt

ROMANIA
René SCHÖB
rene.schoeb@mazars.ro

RUSSIA
Anastasia TEREKHINA
anastasia.terekhina@mazars.ru

SENEGAL
Taïbou M'BAYE
tmbaye@mazars.sn

SLOVAKIA
Mickaël COMPAGNON
mickael.compagnon@mazars.sk

SOUTHERN AFRICAN REGION
Brian BANK
brian.bank@mazars.co.za

SPAIN
Carlos MARCOS
cmarcos@mazars.es

SWITZERLAND
Beatrice BARTELT
beatrice.bartelt@mazars.ch

TUNISIA & LYBIA
Mohammed-Ali ELAOUANI
ali.cherif@mazars.com.tn

TURKEY
Belma OZTÜRK GÜRSOY
bozturk@mazarsdenge.com.tr

UKRAINE
Grégoire DATTÉE
gregoire.dattee@mazars.ua

UNITED KINGDOM
Rudi LANG
rudi.lang@mazars.co.uk

UNITED STATES
James KINNEY
james.kinney@weisermazars.com

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