The framework of risk regulations and guidelines applicable to domestic and global banks and financial service market players has been strengthened subsequent to the 2008 financial crisis. Corrective measures have been taken, and new and improved risk regulation has been introduced, and subsequently the revised BASEL III framework has been implemented.

The BCBS is the primary global standard-setter for prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide in order to enhance financial stability. The objective is to improve and strengthen the banks’ corporate risk governance, transparency, disclosures and ability to absorb shocks arising from financial and country-specific stresses.

The levers used to achieve this objective and the intended risk regulation standards are, primarily: risk capital (CET 1 requirements), liquidity coverage, approved risk model/approaches and guidelines, disclosures, supervisory review and reporting. The entire focus is on how to deal with worst case stressed scenarios, in order to protect counterparties, all clients and banks. This prepares banks and other financial institutions to deal effectively with negative scenarios that occur rarely/once in a few decades. While the idea of risk capital and liquidity regulation is good, it has repercussions on global and regional financial services market players.

The entire risk regulation framework is designed in such a way that establishes a good amount of capital but discourages innovation. Banks and financial institutions have locked up billions of dollars to achieve the 10.5% of RWA capital ratio considered necessary to meet a worst-case scenario with a probability of its happening of less than 1%. However, I believe that the objective of risk regulation should be not only to protect global and regional financial institutions, but also to work as a catalyst to promote innovation, thereby increasing the available capital base to deploy it, improving return on capital and generating employment opportunities.

How can risk regulation be improved to assess risk capital level in a way that achieves the desired state discussed above?
To begin with, risks need to be integrated into corporate strategy and execution. History and the recent meltdown in the global economy have taught us to treat risk management and ethics as part of business strategy and a value creator. The best approach to achieve value creation is through the coupling of risk management and business strategy. Mission, objective, and strategy should be analyzed within the ambit of the enterprise risk program in an organization. This top-down approach to derive risk appetite will help to embed risk culture into the strategy and execution.

**Stress testing and capital planning**

The impact of stress testing and capital planning, and incorporation of the same into risk appetite assessment, is the critical part. The following approach can be used to stress test the intermediate output of an assessment exercise before finalization:

- **Risk capital level I** – Risk capital sufficient to fulfill the enterprise’s risk appetite for conducting normal business activities within a 95+% probability (the risk capital level which suffices for 95% of all risk events will have to be assessed by BCBS and individual financial institutions/banks before finalizing)
- **Risk capital levels II and III** - Sovereign risk, systemic risk, and macroeconomic factors

Before conducting a stress test, the following capital planning metrics need to be evaluated and incorporated:

- Unfavorable and favorable outcomes (a favorable scenario for one business unit may lead to an unfavorable scenario for another business unit, and vice-versa)
- Correlation effects (direction and coefficient)
- Concentrations
- Aggregation and independent, identical distribution
- Distribution

**Classification, definition and assessment of risk levels**

Once the various scenarios (mutually exclusive and/or independent) are analyzed and shortlisted, banks must calculate the level of risk capital required to sustain their business in each scenario. They need to quantify their risk capital based on the BASEL III+ capital assessment. Total capital requirement as per BASEL III is 10.5% of RWA. Based on their risk appetite assessment, banks must then classify their risk capital into Levels I, II, and III and the part of 10.5% that will be allocated to risk capital Level I. Maintaining 5% – 7% Level I risk capital may suffice for internal purposes, but the appropriate Level I risk capital amount should be decided by the banks and the BASEL committee.
Financial institutions should maintain an internal Level I risk capital in the range of 5-7% of RWA.

The effect of this approach will be to free up Level II and III risk capital at banks. This freed-up capital can then be used to generate more returns and introduce innovative products in the market. Financial institutions can apply an incremental risk capital approach that leads to incremental returns. This risk model can potentially pull the world economy higher and lead to innovative products and services, employment opportunities and increase in per capita income.

The role of an independent financial entity to source and manage risk capital

Sovereign governments, with support from G-SIBs and D-SIBs, must establish an independent financial institution (IFE) that will provide Level II and III risk capital to meet risk capital regulation across the industry. This independent financial entity will be funded by government and industry/G-SIBs/D-SIBs and will have financial, administrative and decision-making independence to manage its own affairs. The independent entity will follow the guidelines of regulators/the sovereign and report accordingly. Banks and other financial players may request Level II and III risk capital when required and keep the capital until they regain the required financial stability. The capital will be paid back with agreed interest to the IFE. The IFE will charge interest based on its [cost of capital + margin].

Evaluation of Banks and Financial institutions eligible for the new risk capital model

The diagram below illustrates the high-level approach for an eligibility assessment to qualify for risk capital model.
Now that banks have put the 2008 financial crisis behind them, it’s time for regulators and sovereigns to adopt a new risk capital model that promotes innovation, efficiency, and economic growth as well as financial stability.

Debashis Banerjee

Debashis has more than 18 years of global experience in his professional career. He has worked across financial services, consulting, enterprise risk, and information technology sectors in the fortune 500 companies, and effectively led large multicultural teams at multiple locations. He is presently leading the company as President and CEO and he provides leadership and strategy to global business units and alliances.

He is regularly presenting to global audiences on topics such as strategy and execution, financial services, enterprise risk, and leadership. He has several innovative papers and publications to his credit in the last few years and helped the global financial services players in their approach to handle the challenges effectively. He is part of Board and Advisory council in global organizations and Institutions. He has graduated from Harvard Business School in general management with focus on strategy, leadership, execution, and innovation and has earned the PRM from PRMIA.