

Volume 1 / 2014

 **Reply**
avantage

CRO INSIGHTS JOURNAL





Freddy Gielen
Partner

Freddy Gielen is a Founding Partner of Avantage Reply and CEO of Reply (Benelux & France). Freddy has over 20 years' experience in Prudential Risk, Finance and Regulation. Prior to establishing Avantage Reply in 2004, he worked in Europe, Asia and the United States for two large consultancies, The World Bank and regulators. He holds a Masters in Finance. He is also a Certified Public Accountant (U.S. CPA) and a Réviseur d'entreprises.

Email: f.gielen@reply.eu

About **Avantage Reply**

Established in 2004, Avantage Reply (a member firm of Reply) is a pan-European specialised management consultancy delivering change initiatives in the areas of Compliance, Finance, Risk and treasury.

Website: www.avantagereply.com

A New Forum for Knowledge-Sharing

“The past seldom obliges by revealing to us when wildness will break out in the future”, Peter L. Bernstein

Almost twenty years ago to the day, Alan Greenspan, the then-Chairman of the Federal Reserve Board, declared “there are some who would argue that the role of the bank supervisor is to minimize or even eliminate bank failure; but this view is mistaken, in my judgment. The willingness to take risk is essential to the growth of a free market, capitalist economy.”¹ All of that changed in 2008...

That year will be forever etched into our memories. Until then, financial regulation had been mainly confined to the agendas of technocrats and of subject matter experts. The shockwaves resulting from the financial crisis were sufficient to push financial regulation to the very forefront of the global economic cooperation agenda, bringing it to the level of Heads of States and senior politicians. From then on, financial regulation entered the political arena; and voters, taxpayers and the general public took centre stage. 2008's financial crisis was and still is a ‘game changer’, fundamentally altering the way financial regulation is developed. It transformed the face of Risk forever.

In this context, we recognise the value of contributing to and providing a forum for knowledge-sharing and the cross-fertilisation of risk practices across all industry segments. Daily, we see an insatiable demand for innovation and progress in risk management practices; hence we are launching Avantage Reply's CRO Insights Journal. The publication seeks to fill a gap by helping us all as an industry to better understand, measure and weigh the consequences of risk.

In this first issue, we elected to focus on how the Risk Function in general and the Chief Risk Officer's responsibilities in particular have evolved.

We are privileged to share three leading CROs' insights on these topics. Wendy Phillis, Group Chief Risk Officer for ICAP, highlights how the dialogue between the CRO, the CEO and the Board of Directors has become more open. David Suetens, Chief Risk Officer International for State Street Corporation, draws on the findings of a global survey of risk cultures conducted by State Street and the Economist Intelligence Unit; and discusses the impact of regulatory change on today's CRO. Last but not least, Luc Henrard, Chief Risk Officer for BNP Paribas Luxembourg, discusses the regulatory and risk tsunami that has hit the industry.

I also invite you to watch the accompanying video extracts of these interviews; and I hope you find this first edition as insightful as I have.

¹ Address to Garn Institute of Finance, University of Utah, November 30, 1994.

A handwritten signature in black ink, appearing to read 'Freddy Gielen', with a horizontal line extending to the right from the end of the signature.

Freddy Gielen
Partner Avantage Reply

The Role of the CRO: From Enforcer to Enabler

Wendy Phillis
Group Chief Risk Officer for ICAP

CROs are becoming indispensable in ensuring financial institutions are run well. The recent financial crisis contributed to a change in the way the function is seen. Financial institutions increasingly recognise their importance in all areas of business growth, not solely in terms of fulfilling the regulatory requirements. Michael Roati, Associate Partner at Avantage Reply, talks to Wendy Phillis, CRO at ICAP, about her views on the role of the CRO and the main risks financial institutions are facing.

2



Risk Management in the C-Suite: CRO on Board to Meet the Challenges on the Horizon

David Suetens
CRO of International State Street Corporation

Embedding your Chief Risk Officer's role within the Board structure can have significant benefits in improving its understanding of risk, a recent survey has found. Michael Roati, Associate Partner at Avantage Reply, speaks to David Suetens, International Chief Risk Officer for State Street Corporation, on risk management today, particularly how the economic crisis has changed the role and positioning of the CRO within the business.

8



Regulatory Initiatives: Impact on Risk Management Strategy and Processes

Luc Henrard
Country CRO and Member of the Executive Board, BGL BNP Paribas

For Luc Henrard, Chief Risk Officer for BNP Paribas Luxembourg, "every banker should be a risk manager". Here, he speaks to Stephan de Prins, Associate Partner at Avantage Reply, about his views on the evolving role of the CRO and the importance of collaboration between the risk and compliance functions. He also discusses the increasing pressure of reputation risk and one of the next key challenges facing the CRO: the implementation of BCBS 239, the Basel principles for effective risk data aggregation and risk reporting, and the inadequacy of existing IT arrangements to cope with the challenges it presents.

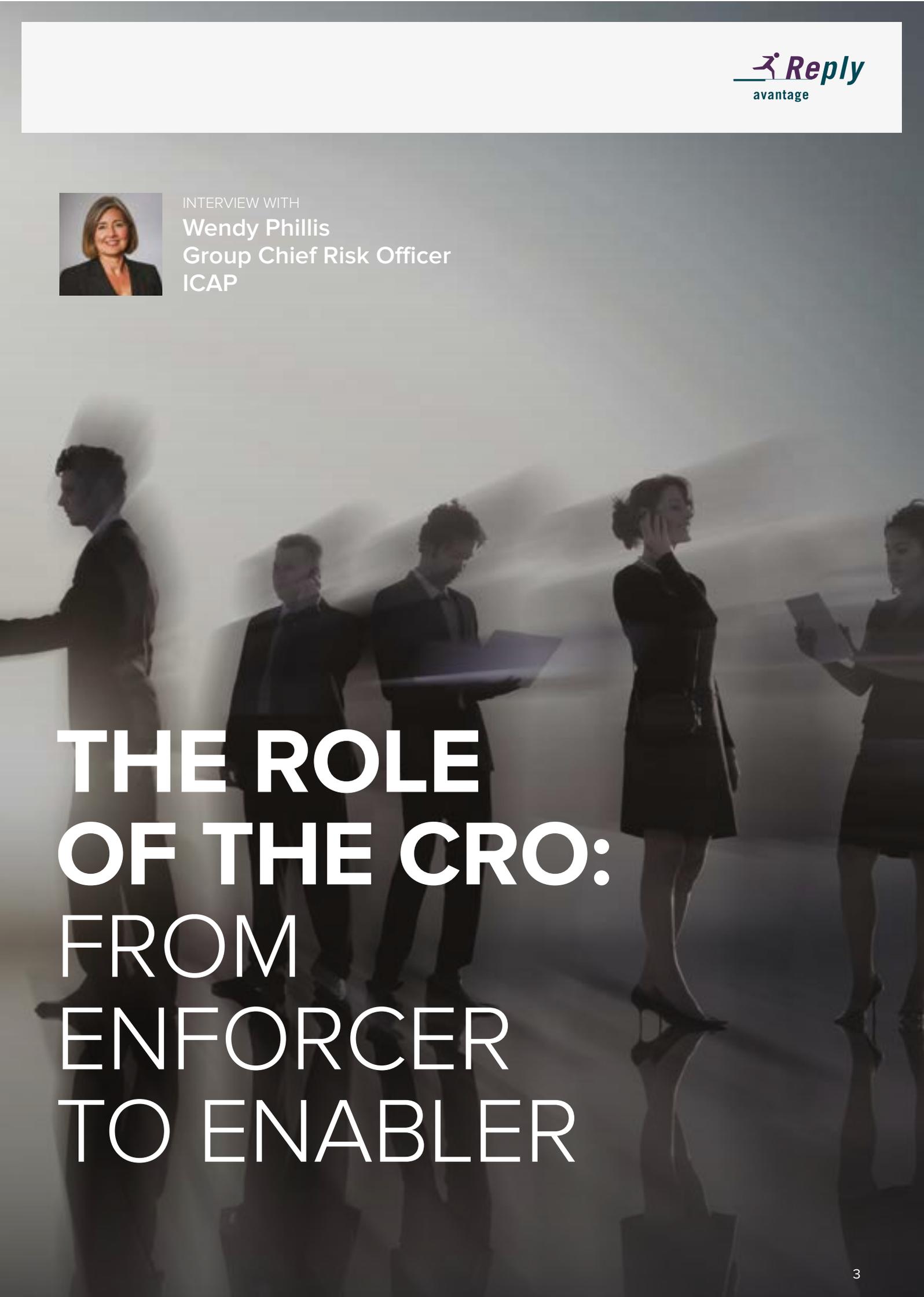
14







INTERVIEW WITH
Wendy Phillis
Group Chief Risk Officer
ICAP

A background image showing several business professionals in a modern office setting. They are silhouetted against a bright, hazy light source, possibly a window. Some are holding documents, and one woman is talking on a mobile phone. The overall atmosphere is professional and collaborative.

THE ROLE OF THE CRO: FROM ENFORCER TO ENABLER

The Role of The CRO: From Enforcer to Enabler

CROs ARE BECOMING INDISPENSABLE IN ENSURING FINANCIAL INSTITUTIONS ARE RUN WELL. THE RECENT FINANCIAL CRISIS CONTRIBUTED TO A CHANGE IN THE WAY THE FUNCTION IS SEEN. FINANCIAL INSTITUTIONS INCREASINGLY RECOGNISE THEIR IMPORTANCE IN ALL AREAS OF BUSINESS GROWTH, NOT SOLELY IN TERMS OF FULFILLING THE REGULATORY REQUIREMENTS. MICHAEL ROATI, ASSOCIATE PARTNER AT AVANTAGE REPLY, TALKS TO WENDY PHILLIS, CRO AT ICAP, ABOUT HER VIEWS ON THE ROLE OF THE CRO AND THE MAIN RISKS FINANCIAL INSTITUTIONS ARE FACING.

How would you say the role of the Chief Risk Officer in financial institutions has evolved in the aftermath of the financial crisis? And how has the CRO's role changed in terms of interaction with the Executive Committee?

In my opinion, the role of the CRO has evolved tremendously since the crisis. A contributory factor to events at that time was that risk was seen by financial institutions as something they had to address, because they were required by the regulations to do so, or because they were in trading businesses and had to manage their risk on a day-to-day basis. The crisis has put much more focus and emphasis on the value of the risk profession. The view of my CEO in the aftermath was that it was the risk management team that actually saved the firm. This was a massive step away from regulation-led risk management. We've already moved on since then. Institutions are realising that the risk function can add value and are beginning to see how they can take advantage of risk management, in addition to the compliance implications. A risk manager is now a champion of change, as well as perhaps a cautious adviser into making sure change is well-structured, well-managed and well-executed. From the management committee's viewpoint, it's much more about how the risk team adds value.

From the Executive Committee and the Board's perspective, it's very similar. In my experience, Board members really rely on the

CRO to help them carry out their responsibilities. Certainly in many jurisdictions, the Board has personal liability for ensuring there are appropriate risk frameworks and tools in place and that the firms are operating as they should be. It's really the CRO, as their inside-the-firm eyes and ears, who helps them carry out that responsibility.

Has the dialogue between the CRO and the CEOs and Board of Directors become more open since the crisis?

It seems to me that, before the crisis, the CRO was called upon only when needed for information about risk. We were there to be the traffic cop, enforcing compliance with the regulations. Since then, though, the role has changed much more to one of a trusted adviser and counsellor. The views of the CRO are often sought out before strategy-setting, in early plans for mergers and acquisitions, for new products and so on. The dialogue now is far more about the business and how to position it to succeed, rather than a tick-box exercise. There's a desire to talk about the risks we currently have and how we're going to mitigate them. In that respect, it's moved on a great deal. The role is still evolving. The idea of having the CRO as a trusted adviser is in its early stages. We need to continue moving from being the business prevention group more towards becoming the business enabler.

It is an uphill battle. However, as CROs build credibility and demonstrate how they and the risk function can enhance the business and add value, then it paves the way, becoming self-perpetuating and aiding the relationship.

Could you expand a little on the relationship between the CRO and the Board of Directors?

In my experience, the CRO has pretty much an open door to the Board of Directors. In my firm, it's a two-way conversation. If I need advice or need to counsel them, we do that offline, outside risk committees; likewise if they have questions for me. I think it's a very collegial, cooperative environment where we're both trusted advisers to each other.

“The view of my CEO in the aftermath [of the financial crisis] was that it was the risk management team that actually saved the firm”

Does the Board of Directors see the CRO as their protector against the penalties or other impacts of financial regulations?

Yes, I think that's one of ways the CRO is viewed. Obviously, directors have responsibilities to shareholders. They have a certain view from outside the firm, and they see the CRO as their eyes and ears internally; to alert them to possible causes for concern and to take action appropriately. That is, in part, how they view the CRO - we're there to help protect them, as well as by extension their shareholders. We help them conduct their duties towards their shareholders and investors, to themselves and to the firm.

You made an interesting point earlier about regulatory requirements. Obviously, under CRD IV and the Dodd-Frank Act, there are increased regulatory requirements for CROs, for CEOs and the Board to comply with the regulations. In the aftermath of the crisis, instances of breaches between CROs and the executive emerged, such as within MF Global, Lehman and other institutions. In the future, will this risk continue, or will the regulations reduce it or help the dialogue?

That's a really, really interesting question. I absolutely agree that the landscape has changed significantly. I think the CRO, the Board and the CEO have personal responsibility in most jurisdictions. Nevertheless, even if it weren't for that, it would be incumbent upon everyone to have an open and honest dialogue about potential risks and hazards in the firm.

It can be a challenge to voice an unpopular opinion and to say, no, especially when CEOs are demanding and businesses are under pressure from the current macroeconomic climate.

The Role of The CRO: From Enforcer to Enabler

Nevertheless, the CRO, the Board and the CEO are all in agreement that we must figure out how to earn as much revenue as possible in a risk-adjusted way. I like to believe the days of the CRO being let go for raising issues or pointing out potential hazards, for example, are gone. We'll see. A CRO with a very firm belief in their own stance could be in a difficult position if the Board and CEO are not engaged.

Are the ever-demanding restrictions on capital, and the demand on optimising capital, an ongoing challenge for the CROs? How are they dealing with the interplay between risk and optimising capital within the firm?

That's when it's even more critical for the CRO to understand the strategy, which in turn drives the risk appetite of the firm. Holding conversations about where the firm could take more risk and where it needs to take less risk are healthy discussions to have.

Optimisation of capital and frankly, liquidity, are two areas that are becoming increasingly difficult as time goes by. The demands of the regulators are sometimes in conflict with the politicians' will, and sometimes it's challenging when you're trying to balance those two things; especially while positioning the firm to earn money.

Potentially this is a difficult question to answer, but with the vast changes in regulations over to Basel II quickly turning to Basel II.5, and then Basel III, and the relationship with the Dodd-Frank Act, how does the CRO view the level playing field across Europe and the globe?

That's a really valid question and I'd like to think there was a level playing field, but frankly there isn't, not within Europe - let alone globally. It's certainly within the domain of the CRO to understand and explain what those jurisdictional differences are; and how firms could potentially use them to optimise their business models and ensure they are able to access liquidity in an appropriate way.

For example, the Dodd-Frank legislation around SEFs and the split of the liquidity we saw late last year into on and off SEF was, I think, an unintended consequence of the regulation. In truth, it was something that could have been quite damaging to economies and financial institutions, if there had been a liquidity event during that time.

“Having a seat at the table at the most senior levels, being part of strategy, and being a trusted adviser is almost an imperative”

I would hope that we're all learning from those unintended consequences and setting ourselves and the regulations up so that, although there may not be a completely level playing field, at least we're not creating more risk for the financial industry as a whole, or even the macroeconomic environment. Understanding those differences and how to leverage them, understanding what products work where and how we can use liquidity globally is a critically important thing for CROs to understand, alongside compliance, legal, regulatory affairs and the businesses, frankly.

The regulations have changed significantly over the years. Do you think levels of regulation are about right, too much or too little?

It's a very difficult question to answer. Rather than whether there's too little or too much regulation, it's more about whether the regulations are working the way they were originally intended.

There are many unintended consequences that, I think unfortunately, will have to be addressed with subsequent regulations. So there's probably more to come, but hopefully it'll be a bit more pragmatic and perhaps more well thought-out.

What are the main messages you would like to deliver in terms of the evolution of the CRO?

First and foremost, having a seat at the table at the most senior levels, being part of strategy, and being a trusted adviser providing input into strategy, is almost an imperative and something where the risk function can add an awful lot of value to financial services firms.

Although we may not have had that seat at the table before, I think we've earned it through the crisis. The big message is that risk is a really important function that can help businesses succeed.



Wendy Phillis

Biography

Wendy Phillis is Group Chief Risk Officer for ICAP, a leading markets operator and provider of post trade risk mitigation and information services.

Wendy joined ICAP in April 2014, after holding a number of senior roles in risk management and compliance at State Street during her 16 years there.

She has also worked at PricewaterhouseCoopers, Fidelity Investments and Investors Bank & Trust Company.





INTERVIEW WITH
David Suetens
CRO International
State Street Corporation

RISK MANAGEMENT IN THE C-SUITE: CRO ON BOARD TO MEET THE CHALLENGES ON THE HORIZON

Risk Management in the C-Suite:

CRO on Board to Meet the Challenges on the Horizon



EMBEDDING YOUR CHIEF RISK OFFICER'S ROLE WITHIN THE BOARD STRUCTURE CAN HAVE SIGNIFICANT BENEFITS IN IMPROVING ITS UNDERSTANDING OF RISK, A RECENT SURVEY HAS FOUND. MICHAEL ROATI, ASSOCIATE PARTNER AT AVANTAGE REPLY, SPEAKS TO DAVID SUETENS, INTERNATIONAL CHIEF RISK OFFICER FOR STATE STREET CORPORATION, ON RISK MANAGEMENT TODAY, PARTICULARLY HOW THE ECONOMIC CRISIS HAS CHANGED THE ROLE AND POSITIONING OF THE CRO WITHIN THE BUSINESS.

Firstly, how has the role of the Chief Risk Officer changed in the aftermath of the financial crisis; in particular, how have the Executive Committee's expectations changed?

The role of the Chief Risk Officer has changed profoundly. What's interesting to see is that it has happened in a self-regulated way. There is no regulation out there which strictly prescribes that the CRO needs to be at Board level. Nevertheless, what has happened in practice is that most CROs with most institutions have indeed risen to Board level. This is evidence that the industry can change. Yes, the global financial crisis worsened things unfortunately; but as a result, the CRO is now much more present at the table – which is something we have seen through our own research.

Could you elaborate on the results of your research?

At State Street, we ran a survey last year in collaboration with the Economist Intelligence Unit. Its overarching aim was to test where risk cultures are from institutional investors' perspectives – so really focused on the Buy Side.

We asked those surveyed what level their CRO is at within the organisation. The finding was that some 63% of institutional investors have a CRO that attends executive board meetings. The interesting point the survey illustrated was that those institutions with CROs at Board level seem to have a better dialogue, and increased transparency, around risk. The result of this is that 87-90% of these institutions stated that they have a robust understanding of the risks their business faces. However, where there was no CRO representation at Board level, that percentage dropped to around 67%. That's a very significant drop.

How have the expectations of the Board of Directors evolved in terms of CRO's contribution?

They've changed in two respects. Once a CRO is at the Board level, he is not simply talking about risk now. He's there to think with the other business leaders about the business strategy and development; and is often deeply involved in product approval.

Secondly, in my experience, the frequency of meetings has also increased, which is a very basic element. No financial institution these days can say that its Risk Committee meets just once per quarter or once a year. Often, they meet anything from once a month to twice weekly.

The interaction is greater and the content is also much richer. Board members' focus on risk has increased tremendously and there is more regulatory pressure on them.

So it's an evolving relationship: where historically the CRO was adviser to the Board of Directors, now the role is more embedded within the Board of Directors itself. Does that create conflicts of interests for the CRO or is it just a natural evolution?

From our research, it's more an evolution of where people are at institutional level. Organisations are now more likely to have a senior Risk Committee with Board members attending. It's not just a Starbucks' meeting, as I call it, between compliance, audit and risk managers. Senior Risk Committees nowadays control functions together with the business, looking at the risks which face the firm.

When this happens, our research shows, the transparency of, and dialogue on, risk data is much more profound. A good committee leads to constant feedback and challenge sessions in order to upgrade the practice. I think that's what everybody is after. It's not a one-time jump; it's a constant development in your risk practice. That continuous growth will need to be proven to your regulators, but also to your different stakeholders.

Certain recent failures, for instance MF Global, provide troubling examples of a breach between the CRO and the Executive Committee, or the CRO and the Board of Directors. This led to a regulatory approach to the CRO

“Those institutions with CROs at Board level seem to have a better dialogue, and increased transparency, around risk”

functional responsibilities, such as CRD IV or Section 65 of the Dodd-Frank Act. How does this affect the CRO's roles and responsibilities within institutions? Is it conducive to a constructive dialogue between the CRO, the Executive Committee and the Board of Directors?

The questions are really: what was the role of CROs in those institutions that got into troubled waters; what was the aftermath; and what are the lessons learnt from that.

In very basic terms, I call it the Belgian farmer common sense approach. When institutions behave in a way similar to MF, for example, that leads to extinction. They're no longer there; it's over and out. Most CROs don't pursue that goal.

To improve and evolve these risk practices, there needs to be a culture around risk which must be embedded in the DNA of the firm. Many of the stories of failure in the past years have arisen where there was no culture of challenge; where people were not listening. Ultimately, the role of the Risk Officer is to play devil's advocate. However, the Risk Officer alone can't do it all by himself. There must be a captive audience that wants to engage in the debate of challenge, risk scenario planning and looking forward.

How do you see your role evolving over the next three to five years?

First of all, it should be a little about fun. But more importantly, it's obvious that interaction with regulators will only increase. Inter-relating with your regulator on new methodologies and new practices within the firm and demonstrating how you are evolving your risk practices will be an important element of the job. Secondly, the newest challenge is stress-testing. Stress testing is a new and important tool.

As we've gone through the first stress test in Europe over the last few months, we have all learnt a lot. We should also take lessons from some of our American colleagues who have been working under this methodology for the last four years. With the results now published by the European Central Bank, we need to reflect on how we make it part of our practice.

Risk Management in the C-Suite: CRO on Board to Meet the Challenges on the Horizon



“Board members’ focus on risk has increased tremendously and there is more regulatory pressure on them”

Stress testing shouldn't be carried out within ivory towers, by a dedicated team. We should also focus on how we embed it within and disseminate results throughout the business; how we educate our colleagues as to where the pressure points are under conditions of stress; and how we implement the mitigating actions. It's critical to then build these into the company's resolution and recovery plans.

The final element is an art that should have existed for many years. Don't be hijacked by your day-to-day agenda, whether it's meeting a regulator, doing the latest liquidity test or stress test or preparing a liquidity report. Also look at what's beyond the horizon. Take time out to consider which risks are coming your way: which geo-political risks exist, which new technology risks are emerging for financial services companies. That will be different depending on whether you're on the asset management side, the insurance side, or a bank. But clearly technology is a big factor, not only bad elements such as cyberthreats and the like, but also looking at new entrants into the market, for example. Interaction with regulators and setting time aside to look at the landscape and evolving new practices will determine our future as a profession.

In an organisation like State Street Corporation, where you have significant operations in the US, and have subsidiaries and branches in different parts of Europe, how does a CRO work with the organisation to ensure, from a global or even pan-European perspective, that it's embedded at the right level within the organisation and is appropriate for the different parts of the business?

Being part of a global organisation, the benefit is sometimes that you have already been confronted by a regulator with a risk practice which is now emerging in another landscape with another regulator. So often, at least you can start to exchange experiences of the work involved. We can look at how our US counterparts handled stress testing when they were first affected and draw on the results of these first-time exercises. We leveraged a lot of that knowledge once we were confronted

with the ECB stress testing here. It's very much about sharing. There are indeed significant differences between the various regulators' demands but that doesn't mean that you can't come together about it and learn from others' experience.

The other point is also not to simply make it a silo exercise executed by people in finance, treasury and risk. Stress testing should not only involve risk people. Over the next two to three months in Europe, with the results now in the public domain, there will be more communication on stress testing and the impact it has on certain financial institutions. So we will be able to link that practice back to the business and the clients. This will help an organisation mature in the way it should look at this new technique.

How does the CRO address the regulatory theme of conduct risk when there's no clear definition of compliance? When organisations are being fined billions of pounds, are institutions' Boards putting the onus on CROs to avoid hefty fines on conduct risk?

The question you are asking seems to be whether CROs are sometimes forced by the Board into only giving attention to the hottest topic of the day. What we need to appreciate is that of course there are now specific teams to deal with issues like cyber security, outsourcing, conduct and liquidity, but it's a question of finding the right balance. You can't forget some of the other areas that you're also meant to cover as Risk Officer. Perhaps internal fraud was a hot topic at a certain moment in the industry, but just because it's no longer on your Board's day-to-day agenda, this doesn't mean you should not still be addressing it within your risk function.

What it means for your team is that, certainly for the newer areas of focus, you should consider having more staff researching and thinking in a more visionary way about them. With the older risk topics, you should still have staff on them, but more a watching brief; part of 'business as usual'. Essentially, you need to make sure that you cover all the risks, both the traditional and the emerging ones, but don't get hijacked solely into focusing your attention on the newer risks.



David Suetens

Biography

David Suetens is an Executive Vice President and Chief Risk Officer International for State Street Corporation, with responsibility for leading the company's risk management function internationally.

Mr. Suetens has over 20 years of experience in the financial services industry in the risk management area. He joined State Street in May 2012 from ING Investment Management Europe where he served as Chief Risk Officer and Board Member. Previously he served as the global head of Compliance, Legal and Risk Management for ABN AMRO Asset Management and was a member of the management team. He holds degrees in investment advice, international banking law and finance.





INTERVIEW WITH

Luc Henrard

Country CRO and Member of the Executive Board
BGL BNP Paribas

REGULATORY INITIATIVES: IMPACT ON RISK MANAGEMENT STRATEGY AND PROCESSES

Regulatory Initiatives:

Impact on Risk Management Strategy and Processes

FOR LUC HENRARD, CHIEF RISK OFFICER FOR BNP PARIBAS LUXEMBOURG, “EVERY BANKER SHOULD BE A RISK MANAGER”. HERE, HE SPEAKS TO STEPHAN DE PRINS, ASSOCIATE PARTNER AT AVANTAGE REPLY, ABOUT HIS VIEWS ON THE EVOLVING ROLE OF THE CRO AND THE IMPORTANCE OF COLLABORATION BETWEEN THE RISK AND COMPLIANCE FUNCTIONS. HE ALSO DISCUSSES THE INCREASING PRESSURE OF REPUTATION RISK AND ONE OF THE NEXT KEY CHALLENGES FACING THE CRO: THE IMPLEMENTATION OF BCBS 239, THE BASEL PRINCIPLES FOR EFFECTIVE RISK DATA AGGREGATION AND RISK REPORTING, AND THE INADEQUACY OF EXISTING IT ARRANGEMENTS TO COPE WITH THE CHALLENGES IT PRESENTS.

In most large financial institutions, the Chief Risk Officer now holds a senior level executive position with overall responsibility for the business’s risk management activities. Nowadays, he or she is tasked with advising other members of the Executive Committee on risk exposures. Specifically in terms of regulatory initiatives, what should the CRO’s role be and is it changing?

That’s a big question! Firstly, it’s important to bear in mind that, within the banking and financial services industry as a whole, we are in the business of managing risk; so if you hedge your potential risk, you will, by definition, hedge all your potential profits. We’re buying and selling risk - that won’t change. From that perspective, I’d argue that every single banker, not just the CRO, should act and think as a risk manager because you do not sell credit risk or market risk in the same way as you’d sell a vacuum cleaner or an iPad.

It’s therefore fair to say that somehow a bank should be articulated around three axes: the first line of defence is the business, which should be risk aware. The second line of defence is the risk function, compliance, IT and finance. Finally, the last line of defence is internal audit, making sure that you abide by the rules, whether they are sophisticated or robust. The risk function’s major task is to ensure that when you’re weighing up the options, you can slot everything into an integrated framework whereby you’re comparing apples with apples. It’s also to make certain that whatever decision is made by senior management, the risk-adjusted return considerations and

the value generated for the bank are always taken into account. Since the 2008 financial crisis, the role of the CRO has become far more critical. The risk function is much more empowered to impose a risk return framework, which should underpin any kind of discussions or strategic decision, whatever transaction-related action the Board might take.

The focus for the financial services industry in 2014 and beyond remains on meeting key implementation deadlines for new regulation. What regulation presents the biggest implementation challenge for you?

The banking industry has been hit by a tsunami of regulations, so it's a never-ending story. Assuming that the big banks and other major worldwide players are essentially ready for the Basel III implementation, then looking forward, my priority concern is BCBS 239: data integrity and the quality and accessibility of data.

Particularly in Europe, there has been a major lack of investment in IT amongst financial institutions. We all know the buzz words about the data warehouse, data mart and so on. But ultimately, it's about governance. Who owns the data? Which department, which front office, which support function is responsible and accountable for the integrity of the data? We need to ensure we can extract that data in an efficient and flexible way. Becoming fully compliant with BCBS 239 will be as challenging as being fully compliant with Basel III. We're talking about a quantum leap as far as data management is concerned, and I question how many Executive Board members are really aware of the implications of these new Basel principles.

IT considerations are less sexy, or less obvious, for Board members. It's nevertheless an essential foundation of how to manage a bank. If you don't have the data to assess the strategy and the risk profile, how will you take your decisions objectively?

In that sense, is the cost of regulatory compliance having a big impact on the change, the business-as-usual functions, and does it have a significant effect on the business model?

Definitely! My bank is part of the BNP Paribas Group. We were heavily fined at the beginning of the year to the tune of US\$8.9 billion. Obviously, I can't comment on the statement

“Every single banker should act and think as a risk manager”

of facts published by the Office of Foreign Assets Control. My recollection is that some of our peers took the liberty of commenting on that statement of facts and were then charged an additional fine so I'll invoke the 5th Amendment. It's clear, though, that the compliance function will be much more empowered in the future.

In my bank at least, the risk function is very independent and has delegated authorities and veto rights. Because reputation risk is becoming such a huge issue, and so many banks have received hefty fines or penalties for their so-called misbehaviour, the Compliance Officer should, in an ideal world, also have a right of veto and be just as empowered and accountable as the risk function. I expect the compliance function to experience a shift from an advisory to a decision-making role.

This would ensure that the reputation of the bank is well-managed. The challenge with handling and managing reputation risk is that it is difficult to quantify in most cases, so we end up in a more subjective domain. But we also know that if you don't handle it well, your brand suffers.

If regulation has become a major source of risk in its own right, what should the CRO be doing about this?

Firstly, the CRO should never give up. One of the big challenges for international companies operating in the financial services industry is the lack of a level playing field. Basel II and Basel III are not applicable to all banks in the United States.

By the same token, the US accounting rules do not converge with International Accounting Standards. It means that there are a lot of arbitrage opportunities. But, if you believe in the efficiency and the fairness of the market, there should be a level playing field.

In concrete terms, I see three priorities for the risk function looking forward. First of all, one of its roles is to frame or control the creativity of specific departments. The corporate investment banking departments tend to be very creative, always coming up with exotic products. And sometimes there is this uncanny tendency to try to arbitrage because on balance, the financial

Regulatory Initiatives: Impact on Risk Management Strategy and Processes



services industry tends to be ahead of regulation. But the name of the game is not to arbitrage too much, at least on regulation, because the danger is that you could trigger a potential reputation risk. The second element, made so clear by new regulations, is that the role of the Chief Risk Officer is very much akin to that of the Chief Financial Officer. The CRO has much more opportunity to be dynamically involved in strategy-setting and raising the Board's awareness of the bank's risk profile. This in turn means that the CRO should be involved when the Executive Committee takes a decision, for instance, to shun off specific businesses; to withdraw from some territories; or where to expand the bank's franchise. Basel III has already had immediate consequences: major players have withdrawn from specific activities because they are too capital intensive and are no longer profitable when evaluated on a risk-return basis. Last but not least, we live in a relative world and we should never expect that to be perfect. Nevertheless, it is so important to make sure that any decision a CEO takes can be benchmarked and objectivised. Coming back to the concept of comparing apples with apples, there are so many different frameworks to assess risk. We speak a lot about regulatory risk but there is also the rating agencies' point of view, which diverges from the regulatory view. On top of that, you have the accounting views, which diverge from the rating agency and the regulatory views. Ultimately, therefore, the Executive Committee is managing the risk-return ratio under specific or different constraints, so will never reach the pareto optimum. An example I often cite is that if I buy a plain vanilla single bond, whether I 'lodge' it on the balance sheet of a bank or an insurance company, in the United States or in Europe, then the required capital for that same risk will be different.

Still, we have to manage under these constraints and the regulatory environment is an important one. But we have to look beyond the regulatory issue, at the economic substance and whether the transaction or portfolio makes sense economically speaking, because we have to manage risk in an economic way. The risk reporting framework is not and never will be perfect. But we should at least make sure whenever we are assessing and weighing in the profitability or potential risk of specific businesses or their territories, that it takes place according to the same risk-return framework.

The financial crisis and recent scandals involving the mis-selling of financial products and market manipulation prompted an increased focus by regulators on the culture of firms and the management of client interests across firms. In your view, what should the CRO be doing to prevent such incidents and respond to the increasing amount of the conduct risk regulation?

Again, reputation risk is everywhere nowadays. I'm anticipating a closer and better cooperation between the risk and the compliance functions. Obviously, know your customer KYC has become an important parameter in the discussion. It's possible to end up with a shallow, mundane KYC approach; or you can go really in-depth because through the KYC, you can ask yourself questions about the strategy, for example FATCA. As a matter of fact, a lot of European banks have asked themselves if it's still worth dealing with US customers. Not because they are unreliable, but because the potential burden of reporting so much information to the US administration means that it's at least worth querying which of the company's departments still want to deal with American customers.

We should also bear in mind that the term 'risk' often refers to the rather traditional taxonomy: credit, operational, trading, ALM, property and casualty, life and health risks. However, strategic risk, reputation risk and the like are just as palatable; but they're not as concrete as the so-called quantifiable risk.

Looking forward, I'm expecting the compliance function to articulate and operationalise itself the same way as the risk function has evolved over time. To reiterate, a closer cooperation between risk and compliance with both functions empowered with veto rights and delegation of authorities should hopefully help us avoid the danger before it arises.

Of course, we are always operating within a specific confidence interval. And the crash of 2008 has reminded us that extreme shocks, albeit with a low frequency and high severity, can have very damaging impacts on the profitability and the solvency of a bank. One thing is clear: we should remain humble because we know that the next crisis is, by its very definition, something that has not been foreseen yet. It's probably a vain hope to think that the new regulations will by themselves prevent us from any major new catastrophe; because the new catastrophe has not yet been integrated within the current governance and the current models.

What's the main message you want to get through?

Risk is here to stay. We are in the business of managing risk. If you hedge all your risks, you will hedge, by definition, all your potential profits. My second message is that obviously, it is in a spirit of cooperation with regulators that we have to make sure that risks are indeed under control. But once again, I would argue that it's up to the shareholders to decide about the risk profile of their companies.



Luc Henrard

Biography

Luc Henrard is Chief Risk Officer for BNP Paribas Luxembourg and holds several Board positions across the BNP Paribas Group. Luc joined BNP Paribas in March 2010 after serving on several Board and Executive committees for financial institutions in Europe and Asia.

He is also a Professor at the School of Management of the Catholic University of Louvain and an Adjunct Professor at the School of Business and Management at the Hong Kong University of Science and Technology, where he teaches in Risk Management, Financial Regulation and Strategy and Corporate Governance, amongst other topics.

Avantage Reply (Amsterdam)

The Atrium | Strawinskylaan 3051
1077 ZX Amsterdam
Netherlands
Tel: +31 (0) 20 301 2123
E-mail: avantage@reply.eu

Avantage Reply (Brussels)

5, rue du Congrès/Congresstraat
1000 Brussels
Belgium
Tel: +32 (0) 2 88 00 32 0
E-mail: avantage@reply.eu

Avantage Reply (London)

38 Grosvenor Gardens
London SW1W 0EB
United Kingdom
Tel: +44 (0) 207 730 6000
E-mail: avantage@reply.eu

Avantage Reply (Luxembourg)

46A, avenue J.F. Kennedy
1855 Luxembourg
Luxembourg
Tel: +352 26 00 52 64
E-mail: avantage@reply.eu

Avantage Reply (Milan)

Via Castellanza, 11
20151 Milano
Italy
Tel: +39 02 535761
E-mail: avantage@reply.it

Avantage Reply (Paris)

5, rue des Colonnes
75002 Paris
France
Tel: +33 (0) 1 71 24 12 25
E-mail: avantage@reply.eu

Avantage Reply (Rome)

V.le Regina Margherita, 8
00198 Roma
Italy
Tel: +39 06 844341
E-mail: avantage@reply.it

Avantage Reply (Turin)

Via Cardinale Massaia, 83
10147 Torino
Italy
Tel: +39 011 29101
E-mail: avantage@reply.it

Xuccess Reply (Berlin)

Mauerstrasse 79
10117 Berlin
Germany
Tel: +49 (30) 443 232-80
E-mails: xuccess@reply.de

Xuccess Reply (Frankfurt)

Hahnstrasse 68-70
60528 Frankfurt am Main
Germany
Tel: +49 (0) 69 669 643-25
E-mail: xuccess@reply.de

Xuccess Reply (Hamburg)

Brook 1
20457 Hamburg
Germany
Tel: +49 (40) 890 0988-0
E-mail: xuccess@reply.de

Xuccess Reply (Munich)

Arnulfstrasse 27
80335 München
Germany
Tel: +49 (0) 89 - 411142-0
E-mail: xuccess@reply.de



Editor disclaimer: The information and views set out in this journal are those of the authors and do not necessarily reflect the official opinion of Avantage Reply. Avantage Reply does not guarantee the accuracy of the data included in this journal. Neither Avantage Reply nor any person acting on its behalf may be held responsible for the use which may be made of the information contained therein.



Visit Avantage Reply's LinkedIn page 

 **Reply**
avantage