

Management for Professionals

Johannes Wernz

# Bank Management and Control

Strategy, Pricing, Capital  
and Risk Management

*Second Edition*

 Springer

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# Preface

This is the second edition of *Bank Management and Control* (2020 edition). This book focuses on bank management and control in terms of strategy, pricing, capital (return on equity) and risk management—in the context of the recent regulatory and macroeconomic developments.

Only recently last adjustments were made to the Basel III rules and their national implementations—with important implications for banks, customers and economy. The political and macroeconomic situation changed considerably in the last few years, too.

Banks are heavily affected by the following macroeconomic and regulatory developments:

- On the one hand, interest rates in different jurisdictions are very low or even negative (like in Switzerland, Germany, Japan); generally interest rates are low (European Union, USA, etc.). This situation got even more pronounced with the coronavirus crisis.
- For mortgage loans and other loans, margins decrease due to the interest rate situation.
- On the other hand, public and private debt increases massively (e.g. in the USA, in many countries of the European Union and in China). This situation got even more pronounced with the coronavirus crisis.
- House prices rise significantly in many jurisdictions.
- Basel III became effective in 2019 (for some important elements, it stipulates the implementation date January 2022).

There is a lot of pressure on business

- Due to low or negative interest rates
- Due to tighter capital

Additional developments have implications, too. Amongst others:

- Coronavirus crisis in 2020
- Conflicts in different parts of the world (like in the Middle East)
- Alienation of the USA-Europe
- Disputes between the USA and China
- Brexit (implications for different countries and sectors)
- The climate change discussion, potentially disrupting some industries

The regulations trigger certain additional things: Resolution and recovery plans (RRPs) are required and must be ready for brisk execution, including potential splitting-up of the business and cutting-off of portfolios; the RRP had and have implications for the legal entity structure of certain banks (e.g. re-establishment of a core division).

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# Short History

Within the last several years (mainly after the global financial crisis), the banking industry and the regulations have changed significantly. The following had and has bigger implications:

- The implementation of Basel II in 2006 (with implications on capital and business)
- The economic and financial crisis that started with the mortgage bubble in the USA and spread to Europe and other parts of the world in 2007 and 2008
- The implementation of Basel III (and intermediate steps like Basel 2.5)—as shortcomings of Basel II were observed during the economic and financial crisis. Basel III became fully effective on 1 January 2019 for those countries that have adopted Basel III
- Low or even negative interest rates
- Increasing public and private debt in many jurisdictions
- Coronavirus crisis

The main topics of this book are management and steering, pricing, capital planning and capital optimization and the implications and implementation of Basel III. Bank management, strategy, pricing, capital planning and risk management are challenged within the perimeters of Basel III. There are and will be shifts in strategy for many banks due to the new regulatory requirements.

Within the economic and financial crisis (starting in 2007), several banks were affected heavily. Within the coronavirus crisis (2020) pressure came back.

- The US Bank Lehman Brothers crashed in 2008.
- In the United Kingdom, the Halifax Bank of Scotland (HBOS)—a merger of Halifax plc and the Bank of Scotland—faced big issues; a merger of HBOS and Lloyds TSB under the new name Lloyds Banking Group resulted.
- The Royal Bank of Scotland (RBS) faced big issues.
- Banks like Dexia in Belgium or Depfa in Ireland were affected.

- HRE of Munich/Germany purchased Depfa, and shortly after the purchase, the economic and financial crisis hit and resulted in massive problems for HRE. HRE could only be saved with the help of the German government and thus German taxpayers.
- Many of Germany's Landesbanken completely underestimated the risks associated with securitized products (such as CDOs) and faced significant trouble beginning in 2007. The Landesbank of North Rhine-Westphalia, the Düsseldorf-based WestLB, was particularly hard hit.
- During the crisis of 2007 and, in the subsequent years, UBS requested help from the Swiss state and the Swiss National Bank (SNB). UBS had underestimated the risks associated with securitized products (CDOs) and faced huge losses.
- IKB, a Düsseldorf-based bank (associated with the German state), invested massively in securitized products from the USA and faced massive losses.

If one bank faces a problem, many other banks are also affected. In the financial crisis regulators faced a situation in which regulatory requirements were deemed to be insufficient. As a result, regulatory requirements were adjusted (Basel 2.5 and Basel III). Depending on the business model of a bank, adopting the new regulatory requirements had and will have significant implications for the bank's capital allocation. The risk/return management of most banks is affected strongly.

# Motivation and Goal

Regulatory requirements for capital do have a huge influence on the return, and risk modelling has a significant influence on the capital requirement and pricing for the corresponding business segment. Risk modelling, therefore, has an impact on the return of equity (RoE) of the corresponding business segment. It is part of the philosophy (since Basel II, re-emphasized with Basel III) that incentives are provided for a good and granular risk management. The improvement of risk management and the increase of granularity within risk management are often rewarded with lower capital charges. The book shows many relevant focus areas with potential rewards (including the technical details).

This book provides a systematic in-depth overview of all areas that are relevant to the management of risk and return and therefore to banks' strategy. The discussed topics are embedded in the context of the regulatory requirements of Basel III and the national implementations (e.g. Eigenmittelverordnung in Switzerland, Capital Requirements Regulation in the European Union, etc.). This book often focuses on the advanced approaches within Basel III, as the advanced approaches provide most opportunities for improving risk management and thus provide leeway for strategic considerations.

An overview of Basel III—the regulatory rules specifying the requirements for capital and reporting on risks—is given. The national implementations are discussed to some extent, too. The philosophy of Basel III is carved out and important details are emphasized.

Terms like “Basel III”, “Basel”, the “Basel Rules” and the “Basel Accord” are used synonymously in this book.

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Psalm 136:1—O give thanks unto the LORD; for he is good.

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