

Management for Professionals

Johannes Wernz

# Bank Management and Control

Strategy, Capital and Risk Management

 Springer

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Johannes Wernz  
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## Preface

These are challenging times for banking. Within the last several years, the banking industry has changed significantly due to the global financial crisis. As a reaction to the macroeconomic situation, an entire series of governmental and new regulatory requirements have been implemented to meet the new developments and previously underestimated risks.

This book focuses on bank management and control in terms of strategy, capital, and risk management in the context of the recent macroeconomic and regulatory developments. Such developments include the following:

- The implementation of Basel II (and the corresponding national standards such as BIPRU in the United Kingdom) in 2006
- The economic and financial crisis that started with the mortgage bubble in the United States and spread to Europe and other parts of the world in 2007 and 2008 (see Sect. 3.9.2)
- The worsening situation regarding public debts in the United States in the early years of the new century and the corresponding downgrading of the U.S. federal government by a credit rating agency (the first time that one of the agencies had downgraded the U.S. government)
- The increasing debt situation in Europe and especially in the EU, which led to increased problems within the monetary union (Euro)
- Problems with sovereign bonds (according to Basel II, BIPRU, and other national implementations, these were considered as being risk free; therefore, as a result, banks accumulated lots of government bonds)
- The changes in Basel 2.5 that were first implemented in Switzerland and later in other countries
- The implementation of Basel III – as shortcomings of Basel II were observed in the economic and financial crisis

The main topics in this book explore management and steering according to desired return, capital planning and capital optimization, and the implementation of the Basel Accords. Bank management, strategy and capital planning, and risk management are challenged within the perimeters of Basel 2.5 and Basel III. Going forward, there will be shifts in strategy for many banks due to the new regulatory requirements.

Beginning with the economic and financial crisis in 2007, several banks faced specific damaging consequences:

- The U.S. bank Lehman Brothers crashed in 2008, despite expectations that the U.S. government would rescue the bank.
- In the United Kingdom, the Halifax Bank of Scotland (HBOS) – a merger of Halifax plc and the Bank of Scotland – faced serious issues. A merger of HBOS and Lloyds TSB under the new name Lloyds Banking Group resulted.
- The Royal Bank of Scotland (RBS) also faced big issues. As a consequence, in 2013, about 82 % of the RBS is still owned by the U.K. government.
- Other banks such as Dexia in Belgium and Depfa in Ireland were negatively impacted as a result of their refinancing schemes. The banks did their refinancing short term, whereas the lending was long term. As interest rates developed to their disadvantage within the crisis, huge losses were incurred. Although Dexia was bailed out with the help of Belgium's tax payers, the bank once again faced new difficulties in 2011 because it had accumulated many sovereign bonds.
- The bank HRE of Munich, Germany, purchased Depfa, and shortly after the purchase, the economic and financial crisis hit and the above-mentioned refinancing scheme resulted in massive problems for HRE. HRE could only be saved with the help of Germany's government and thus Germany's tax payers.
- Many of Germany's Landesbanken, mostly belonging to German states such as North Rhine-Westphalia, Bavaria, or Saxony and to local Sparkassen (thrifts), misjudged the risks associated with securitized products like collateralized debt obligations (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 of Switzerland requested help from the Swiss state and the Swiss National Bank (SNB). UBS had misjudged the risks associated with securitized products (CDOs) and faced large losses. Concentrations within its portfolio (such as securitizations from the United States) were detected too late.
- In addition, IKB, a Düsseldorf-based bank (associated with the German state), which invested massively in securitized products from the United States, also faced massive losses.

Almost every big bank is internationally invested and therefore is very much affected by influences originating from almost any part of the globe. If one bank faces a problem, many other banks are also affected. Regulators faced a situation in which regulatory requirements were deemed to be insufficient. Therefore, regulatory requirements were adjusted and expanded. Depending on the business model of a bank, adjusting to new regulatory requirements will have a significant influence on the bank's capital allocation. Thus, the risk/return management of the banks is affected strongly. Regulatory requirements for capital do have the most prominent influence on the return these days.

Risk modeling has a significant influence on the capital requirement for the corresponding business segment. Risk modeling, therefore, has an impact on the return on equity (RoE) of the corresponding business segment. It is part of the Basel

II philosophy that incentives are set to implement a good and granular risk management. So the improvement of risk management and the increase of granularity within risk management are often rewarded with lower capital charges. Generally, the return on equity will be reduced when Basel III goes into effect. To partly compensate for this, many banks will improve their risk management and the corresponding processes and governance within the next few years. But even expensive projects aimed at improving the systems are often “highly profitable” as they can have a big influence on the return.

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 represented by the Basel Accords (Basel II and Basel III) and the national guidelines. This book focuses on the advanced approaches within the Basel Accords (see Sect. 3.7), as these advanced approaches provide most opportunities for improving risk management and thus for strategic considerations.

An overview of the Basel Accords – the regulatory rules specifying the requirements for capital and reporting on risks – is given. Also the national implementations of the Basel Accords – such as BIPRU in the United Kingdom, the Rundschreiben in Switzerland, and the Solvabilitätsverordnung in Germany – are discussed in Sect. 3.7. The philosophy and evolution of the Basel Accords are discussed and important details of the rules are emphasized.

Terms like “Basel,” the “Basel Rules,” and the “Basel Accords” 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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