

# The Challenge of Changing Risk Regulation in Russian Banks:

## How they can minimise compliance cost, derive strategic value, and build strategic advantage

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*Russian banking is undergoing a revolution in risk management practices. The aftermath of the banking crisis of 2008, and the global regulatory response, is now having a large and direct impact on Russian banks. Many are spending substantial amounts of money to prepare for compliance with Basel 2 and 3, and Boards are exploring how to minimise these costs and at the same time derive some value. In some cases, the "Basel paradigm" is calling into question risk management practices that seem to work effectively in the Russian market. The rate of market change and volatility, and the global economic situation, place an even higher premium on developing effective answers to these challenges.*

Furthermore, modern risk management is not just about policing and limiting exposures. Risk management today has to be up to the tasks of capital planning, risk-adjusted profitability calculation, quantitative approaches to risk appetite and strategy, and regulatory reporting, among other complex goals. This multifaceted agenda is making the war for risk talent in Russia a very hot one – there are very few who both understand modern risk management and the realities of Russian banking. And as risk management becomes intimately related to strategy, Boards and senior management need to understand modern risk management much better than they currently do. Even major shareholders owe it to themselves to understand better the risk-adjusted returns of their institution. They also need to examine whether management has the right balance of investment in building the bank's risk management data, framework, and governance processes.

The new Risk management paradigm has been evolving by many financial institutions to be a more structured process to assess, mitigate and monitor the risks that an institution is exposed to. Before the start of the financial

crisis, many Russian banks typically viewed risk management as a support function, essentially a compliance requirement enforced by conservative regulators. An important lesson learned through the financial crisis is the need to have a dynamic risk management function to help drive sound business decision-making.

Banks are working hard to evolve their risk management function. The new approach to risk management should at a minimum be characterised by a clearly defined risk appetite and governance structure so that there is sufficient capital and liquidity available at all times. It should be clear that risk management is no longer only about compliance but that it is taking an active part in the decision making process.

Giving the risk management function this elevated role addresses three critical issues:

- Protecting the financial institution against the threat of financial distress
- Minimising regulatory interference in key business decisions
- Anticipating further regulatory developments and minimising the cost of compliance

### PROTECTING THE FINANCIAL INSTITUTION AGAINST THE THREAT OF FINANCIAL DISTRESS

We live in a volatile and hard to predict world, especially in the Russian banking market. We have seen how rumours about liquidity and capital sufficiency can quickly create runs on banks in the current febrile times. And the cost of this distress to shareholders and debtholders is clearly too high to bear. Even if regulators step in to help save the institution, there are substantial costs in terms of strategic and financial flexibility. It is better to stay ahead of the game. Maintaining stability through the volatility ahead of downturns in the cycle should be the bank's objective. It is true that here in Russia there are clearly signs of good growth prospects in lending products, and product penetration levels are low relative to the rest of Europe and North America. However, there are many potential threats on the horizon that could damage the outlook for Russia's banks. We should not forget the experience of late 2008 and early 2009 and the enormous shareholder value destruction of those months. Slow growth in the United States and the sovereign debt crisis in the Eurozone are both sobering threats.

We are seeing a tightening in interbank markets and liquidity which is somewhat worrying. It is only prudent for Russian banks to take action to protect themselves from potential problems, and one of the necessary actions is to build more robust risk management approaches.

#### **MINIMISING REGULATORY INTERFERENCE IN KEY BUSINESS DECISIONS**

Shareholders, boards, and senior management understand that doing business in the post-crisis world is a new game and requires a different strategy, judgments, and rule set. Regulators are going to impose new rule sets and a wise institution will anticipate and address the substantive concerns of the regulator and other stakeholders. And even though implementation of the Basel accords in Russian banking will be expensive, one valuable aspect of Basel is it provides a common terminology and analytical framework between regulators and banks. For example, the requirements of Basel II related to Pillar 1, if managed properly will enable the financial institutions to numerically capture the core risk weighted assets and help drive more robust measures of risk-weighted product and customer profitability. Pillar 2, as another example, can be the rule set through which banks are able to cover risks beyond and above those calculated under Pillar 1.

Enlightened management, though, also needs to take into account the Basel accords are not perfect and that protecting the institution requires judgment rather than “box ticking”. For example, one of Basel 2’s shortcomings was that it reflected a focus on risk weighted assets and not so much on capital and liquidity. Basel 3 should basically cover this weakness by introducing new measurement metrics into the availability of capital and liquidity buffers. Banks are now more sensitised to the risks that liquidity will dry up in a crisis.

A well established risk management function can as well serve as an effective tool to demonstrate management’s risk focus to regulators, shareholders and public.

#### **ANTICIPATING FURTHER REGULATORY DEVELOPMENTS AND MINIMISING THE COST OF COMPLIANCE**

There is little doubt that the regulatory environment will become harsher and will be more comprehensive than in the past. Bank Managements are challenged to deal with developing and contradictory regulations across countries and the need for clarification on a large number of new rules and requirements.

Particularly as the Russian banks are embarking on their way to get prepared for their Basel 2 risk management programme objectives,

a reasonable strategy would be investing according to the long term expectation of regulatory change in order both to meet the requirements of Basel 2, and to establish a strong culture to monetise the benefits of more advanced risk management applications. This will, however, require investing in new systems and processes, applying more quantitative techniques to assess risk, and establishing a strong risk oriented reporting framework enabling management to monitor and manage risk according to the new paradigm. Banks will need to assess the costs and benefits of such investments in potential future change as opportunities emerge.

#### **CONCLUSIONS**

Banks in Russia have advanced substantially in their risk management efforts. However, there is still a great deal to be done. This is especially true as the external market and regulatory environment remains challenging, and new regulations appear frequently. Adopting a comprehensive long term risk management strategy helps banks to see beyond the risk management tasks on a day-to-day basis, and give bank management a clear direction for the next steps ahead.

