RESHAPING BANKING FOR CHANGING TIMES:
CHARTING A COURSE FOR SOUND AND SUSTAINABLE GROWTH

Keynote Address by

Michael J. Zamorski
Adviser, Financial Stability and Supervision
The South East Asian Central Banks (SEACEN)
Research and Training Centre

at the

26th ANNIVERSARY CONVENTION OF ASSOCIATION OF PROFESSIONAL BANKERS – SRI LANKA

Colombo, Sri Lanka

16 October 2014

Welcome and Introduction

Your Excellency Mr. Arith Nivard Cabraal, Governor of the Central Bank of Sri Lanka; The Honorable Mr. Piyal D. Hennayake, President of the Association of Professional Bankers – Sri Lanka; Distinguished Members of the APB's Executive Council; Distinguished Guests and Delegates; Ladies and Gentlemen – Good evening. It is indeed a privilege and a pleasure to be here and to have this opportunity to share some thoughts on meeting the future challenges confronting the Sri Lankan banking industry. At the outset, let me state that the views expressed are my own, and do not reflect those of The SEACEN Centre or its membership.

Banks play a critical role in countries' ability to achieve sound, sustainable economic growth, which is a prerequisite for financial stability. Banks are the main suppliers of affordable credit to consumers and small businesses. By meeting the sound credit needs of the communities they serve, banks enable entrepreneurs to build profitable businesses that provide stable, long-term employment, and allow their employees to accumulate savings and wealth to improve their standards of living.

Banks help many people who have previously been "unbanked" become part of the financial mainstream by providing convenient access to financial services at a reasonable cost.

More than seven years have passed since the 2007 onset of the U.S./Eurozone Crisis. Many countries most directly affected by the Crisis are still facing economic challenges and structural adjustments. Despite extraordinary policy actions by central banks and monetary authorities, the pace of recovery has been uneven and generally sluggish. Recently, it appears that economic performance in parts of the Eurozone has weakened dramatically.

In countries at the epicenter of the Crisis, asset prices, primarily commercial and residential real estate, have been slow to recover even though central banks have kept interest rates at or near zero for an extended period. A large inventory of foreclosed properties and real estate loans in the process of foreclosure continues to inhibit both market clearing processes and price recovery.

By contrast, Asia Pacific, while not immune from the Crisis, has experienced mostly second order effects -- primarily the impact of the global recession that ensued. Currently, most of the region is exhibiting relatively stable macroeconomic conditions and output growth. However, there is concern over the potential regional impact of cessation of accommodative monetary policy and extraordinary policy measures such as quantitative easing.

The Convention provides a valuable opportunity for delegates to discuss these concerns, other risk issues, industry priorities, and other challenges that lie ahead. Of particular value will be delegates' discussions as to ways the Sri Lankan banking industry can continue to play a key role in promoting and contributing to the country's future economic growth and development.

My goal this evening is to offer some perspectives and insights that will be useful to those discussions. I will focus my remarks on three main considerations. First, what risks do banking industry participants believe pose the most concern? Second, what are some other significant near term challenges to economic activity and bank performance? Lastly, what are some of the key success factors for banks in successfully implementing sound business strategies in an uncertain and potentially challenging environment?

"Banking Banana Skins"

The Centre for the Study of Financial Innovation is a non-profit, London-based "think tank" that produces, in association with PwC, a biennial survey entitled "Banking Banana Skins." Beginning with their first survey in 1996, CFSI has ranked the most important risk issues facing the global banking industry. Their latest survey, released in May, is based on input from 656 respondents from 59 countries who were canvassed during January and February. Survey respondents include bankers, risk managers, regulators and close observers of the global banking industry. They were asked to describe their main concerns about the financial system over the next two to three years.

At the top of the global rankings of the greatest risks facing the banking industry is concern about over-regulation, though that result primarily reflects opinions voiced by European and North American respondents. The survey notes "a high level of concern that (new) regulation will leave the banking industry better capitalized, but so burdened with rules and requirements that it will be unable to generate sufficient profit to flourish, or compete with more lightly regulated parallel sectors." There is also concern about compliance costs, inconsistent application of new regulations and the possibility that certain activities will be driven to the shadow banking system, where they will be unregulated and could potentially pose a threat to financial stability.

The rest of the top five global risks are:

2. Political interference – closely related to over-regulation are concerns about governmental and regulatory overreach;

3. The macro-economic environment – the continued economic fragility I previously mentioned and risks posed by the unwinding of various post-Crisis stimulus measures;

4. Technology risk; and

5. Profitability concerns (mainly due to the cost of implementing new regulations; lingering unrecognized bad debt write-downs; competition by less regulated or unregulated financial services providers).

Asia Pacific responses to the survey reflected somewhat different concerns. The top five risks are:

1. The Macro-economic environment;

2. Interest rates;

3. Technology risk;

4. Pricing of risk; and

5. The quality of risk management.

Also, Asia Pacific is "the only region that sees attracting and retaining talent as a top ten (No. 7) risk issue."

Let me offer a few thoughts about these survey findings.

Post-Crisis Regulatory Changes

The onslaught of new regulations over the past few years primarily relates to the post-Crisis reform agenda being pursued by international standards-setters such as the Basel Committee on Banking Supervision. Since these are international standards, and based on member country consensus and input from industry consultations, there is an expectation that countries will adopt them. However, countries' implementation strategies need to reflect any unique national circumstances and implementation timetables need to provide reasonable transition periods. Also, the banking industry needs to weigh-in during countries' industry consultations regarding content, impact and implementation. The cost burden of new regulations will, unfortunately, disproportionately impact smaller banks due to their lower operational scale.

Technology Risk

One of the most dramatic changes since the last Banana Skins survey in 2012 is a much higher focus on technology risk, which has "historically been seen as low order." This risk area jumped from No. 18 to No. 4 in the global survey, primarily because of growing concerns about the vulnerability of outdated systems to cybercrime and outages, and the perceived low priority assigned to this risk by bank managements. The survey also notes "growing concern about cybercrime (hacking, identity theft and phishing) where banks have become criminals' main targets and where the opportunities are expanding all the time."

Banks are highly dependent on information technology and communications. High quality data management and analytical capabilities are essential to achieving effective risk management and informing strategic and tactical decision-making. There are strong competitive pressures to provide customers with 24 X 7 on-line account access using the latest technology. Any disruptions in systems and services, or even perceived problems, can result in financial and reputational damage.

Bank supervisors consider banks' boards of directors to be the "first line of defense" in proactively overseeing the management and control of the financial, operational and reputational risks in their institutions. Banks' boards of directors and senior executive management have a fiduciary responsibility to control risks, including those emanating from information and communications technology.

Cyber Security Risk

On 25-26 August, The SEACEN Centre sponsored a Cyber Security Summit, which included global cyber security experts and regional regulators, to discuss the nature of cyber security risk and the threats posed to banks. One concise definition of cyber security is "the body of technologies, processes and practices designed to protect networks, systems, computers, programs and data from attack, damage or unauthorized access."[1] This definition implicitly encompasses banks':

- cyber risk control environments;
- corporate governance and risk management and oversight capabilities;
- the need for ongoing understanding of changing vulnerabilities and risks; and,
- the ability to handle any adverse events or breaches through appropriate incident response capabilities.

Common cyber security risk management areas for banks include:

- protecting networks, systems, computers, and program vulnerabilities;

[1] Source: whatis.techtarget.com/definition/cybersecurity

- protecting the integrity and confidentiality of customer data;
- outsourcing/third party dependencies;
- cross-border dependencies;
- legal and reputational risks;
- regulatory risk; and
- business continuity and contingency planning.

What constitutes an appropriate level of board engagement and management oversight with respect to cyber security risk? At the Summit, a key message to banks' boards of directors resulting from the discussions is that cyber security risk is a key strategic business issue, not an operational matter to be delegated to the IT department. Given the unrelenting pace of technological advances, there must be meaningful, informed, ongoing board and senior executive management engagement. Pre-implementation due diligence for new technologies should receive board consideration so there is a clear understanding of the attendant risks. A board Audit or Risk Committee should monitor cyber security risk on an ongoing basis and the full board of directors should receive regular updates.

Threats to Profitability

Competition in the banking industry, including competition from less regulated providers of financial services and shadow banks, will continue to pressure bank profitability. Cost control will receive greater emphasis. Care needs to be taken to ensure that necessary risk control and compliance functions are not undermined in the name of cost containment.

The substantial regulatory reform agenda resulting from the Crisis is having, and will continue to have, significant cost and resource implications for the banking industry. Changes in business practices resulting from the regulatory reform agenda mostly relate to enhancing risk management practices and corporate governance. Most of these changes are motivated by establishing adequate checks and balances to prevent excessive risk taking. Changes in business practices are also driven by advances in technology and competition from less or non-regulated providers of financial services.

Aside from higher costs, bank profitability is under pressure due in part to low loan demand resulting from slowing economies. Price competition has also reduced profit margins and there is some evidence of underpricing of risk.

There is a saying in bank lending circles that “bad loans are made in good times.” This alludes to a tendency, observed during previous credit cycles, to relax loan underwriting standards during periods of strong economic growth, and not fully evaluate or stress test secondary sources of repayment, since default appears to be a remote possibility.

Interest Rate Risk

As I mentioned, there is concern among emerging market policymakers about potentially adverse impacts when extraordinary central bank policy measures undertaken in the West are eventually withdrawn. Due to zero interest rates policies undertaken to moderate the Crisis, Asia Pacific countries experienced substantial capital inflows in search of better returns available in the region. In fact, some regional jurisdictions had to take macroprudential measures to curb the formation of potentially destabilizing, speculative bubbles, such as sharp rises in commercial and residential real estate values resulting from capital inflows. We have already seen some currency exchange rate volatility from the very threat of policy actions that would likely precipitate large capital outflows.

Due to weak loan demand, some banks have enhanced earnings by funding the purchase of longer-term fixed rate assets, such as debt securities, with short-term, lower cost deposits. This strategy poses significant interest rate and funding risk. A rise in interest rates could reduce or eliminate interest rate spreads through rising funding costs and reduce the value of the longer-term fixed rate assets acquired. Also, rising rates could produce exchange rate volatility and cause increased repayment risk in loans denominated in foreign currencies.

In recent years, corporate and consumer loan customers have obtained variable rate loans at a time of historically low rates. Do these borrowers have the capacity to meet higher debt service requirements that could result from rising interest rates? Have banks adequately considered this risk in loan underwriting and pricing decisions? Do bank stress testing protocols and capital planning activities adequately consider these risks?

Another risk issue that did not appear on the global and regional risk survey list but, nevertheless, may pose challenges relates to

Impending Changes in Loan Loss Reserving Methods

One of the reforms arising out of the U.S./Eurozone Crisis is a fundamental change in the approach to the accounting for, and financial reporting of, loan loss provisioning. On 24 July 2014, the International Accounting Standards Board announced that, effective for annual financial reporting periods beginning on or after

1 January 2018, the “incurred loss” model of loan loss provisioning (i.e., loan losses are recognized only when “evidence” of impairment exists) in existing International Accounting Standard 39, will be replaced by International Financial Reporting Standard 9, which uses an “expected loss” approach to loan loss provisioning. The potential implication of this change is that banks may need to establish loan loss reserves that substantially exceed present levels, resulting in reduced earnings. While 2018 seems distant, the standard setters are permitting, and in fact encouraging, earlier adoption.

It is difficult to precisely determine the potential impact of this new approach. However, when discussing the proposed new IASB standards in a December 2013 speech, IASB Chairman Hans Hoogervorst stated that “Our field work shows that it will lead to a significant rise in the level of provisioning.” Some industry experts estimate that required loan loss allowances could double or triple, though other analyses show a lesser impact, in the neighbourhood of a 50% increase in reserves systemwide if applied today. The impact will vary depending on loan portfolio composition and economic conditions at the time of implementation.

Now please permit me to provide a few perspectives on the key success factors in successfully meeting future industry challenges.

Corporate Governance and Risk Culture

Successful banks depend on leadership and strategy execution by experienced, dedicated professional bankers. Bankers’ most important skill is their professional judgment. Judgment based on experience. Bankers must have expertise not only in finance, but also require in-depth practical knowledge and experience in related fields such as accounting and law, to be able to conduct business prudently in a competitive marketplace. They must possess a level of business acumen that allows them to give sound advice to their clients.

Why do “similarly situated” banks have different outcomes? Some succeed and prosper while others underperform or encounter problems that can even jeopardize their viability. Banks’ corporate governance, risk management capabilities and risk culture are the main differentiating factors in bank performance and soundness.

A primary determinant of bank financial performance and soundness is an independent, actively-engaged and vigilant board of directors that serves as an effective “check and balance” on excessive risk taking. Board members are generally highly capable people who are well aware of the need for careful judgment and processes that can be justified and defended, and who know the potential impact that poor decisions can have on the success of the business, shareholder value, and director liability. Notwithstanding this fact, improvement opportunities in the judgment processes of directors are likely available.

Corporate governance is enhanced when directors improve their ability to exercise an appropriate level of skepticism and actively engage with management. Banks and their key stakeholders are better served when directors constructively challenge management’s judgments, explicitly consider alternative perspectives, and engage management in frank and open discussions.

Unfortunately, sometimes boards have been reluctant to voice concerns, adopting an attitude that might be characterized as “go along to get along.” However, at the opposite extreme are boards that insinuate themselves into very detailed operational matters and tend to micro-manage executive management. Somewhere in between – allowing management reasonable latitude and discretion to do their job with appropriate board oversight and accountability – is probably optimal. Also, micro-management by the board could be an indication of a lack of trust or confidence in management's capabilities.

Bankers must ensure that they have a control environment which results in sound risk selection and pricing, and protects the safety of depositors' funds.

Boards of directors can improve their strategic outcomes by avoiding "short termism" and taking a longer term view in their decision-making. The reporting of quarterly financial results and related market expectations tends to focus on short-term results. However, banks should also be making strategic investments to prepare for future challenges, even though the resultant rewards and benefits may only be apparent in the future.

What is organizational culture and why is it important? I would describe it as the collective beliefs and behaviors that occur "at the ground level" in an organization – that is, what people actually believe and do, which may differ from formal policies and procedures, mission statements, etc. For example, lending officers are undoubtedly conversant with their bank's formal lending policies and guidelines, but they should also have a well-tuned practical sense as to how specific loan proposals relate to the organization's risk tolerance, and how they will be received by the board and senior executive management.

Organizational behaviors are usually driven by perceived incentive and rewards systems. Leaders need to model desired behaviors and make sure incentive and reward systems are compatible with strategies and desired outcomes.

When I worked as a bank Chief Risk Officer, our C-suite executives would meet annually for at least day, and have a detailed discussion about any changes needed in the bank's policies and procedures, delegated authority and/or control structures, to ensure that they were consistent with current organizational risk tolerance and actual practices. When changes were made, there was clear and prompt communication of the changes and the business reasons behind them, to affected team members to increase awareness and buy-in.

Risk Management Processes and Governance

Bank risk management and other control processes, such as internal audit and the loan review function, must consider, among other things, institutional size and complexity, business models, financial strength and the competitive environment. Control processes involve careful judgment, and their operation should avoid a mechanical, checklist approach that presents the danger of becoming a substitute for thought and sound judgment.

Organizational attitudes toward risk management, control functions and compliance need to be constructive and supportive. In some banks, the compliance function is viewed negatively and sometimes portrayed as providing little value – it may be pejoratively referred to a "cost center" and even as a business inhibitor. This attitude is unhealthy and possibly dangerous. Compliance should be viewed as a "cost avoidance center" and the Chief Compliance Officer should have sufficient stature and respect within the bank so that the control functions under his purview are taken seriously. There should be credible career opportunities in the control areas to attract talented people to these key functions.

Concluding Remarks

The Convention provides a valuable opportunity for you to take a break from the press of daily business and think about the key strategic issues and challenges confronting the banking industry and your institution. How will we meet those challenges, and how will our bank will fit into the ever-changing competitive landscape? Past success is no guarantee of future success.

One of the key challenges in formulating strategy is to look out over the horizon and try to anticipate what products and services and business models will be necessary to meet customers' needs. Should we form strategic alliances with non-banks in offering services in order to meet our customers' needs?

Many challenges lie ahead. There is no doubt that the talent and resolve of the professional bankers here today is more than equal to the challenges I have mentioned. While Convention delegates may be competitors, they all have the same goal of advancing the Sri Lankan economy, which will benefit everyone in the longer term, enhancing the nation's business climate and the ability of its people to improve their circumstances and fully participate in the financial mainstream.

I hope your discussions are productive and insightful and produce actionable outcomes that will benefit Sri Lanka's financial stability and economic development. The professional bankers of Sri Lanka have been major contributors to Sri Lanka's economic growth and development. Please accept my sincere compliments to the President, Executive Council and the members of the Association of Professional Bankers - Sri Lanka for their important contributions to Sri Lanka's progress and my best wishes for their future endeavors to help to make Sri Lanka the Wonder of Asia in the near future. My best wishes for the success of the 26th Anniversary Annual

Convention of the Association. Once again, thank you for allowing me to share my thoughts with you this evening.