Professional Perspectives on Banking and Finance, Volume 1

PROFESSIONAL PERSPECTIVES ON BANKING AND FINANCE

Editor
Moorad Choudhry

Professional Perspectives on Banking and Finance is a collection of cutting-edge articles written by practitioners for practitioners. Each volume addresses core topics such as risk management, corporate governance and strategy, but with the emphasis on recent developments and their impact on the industry. Articles will not discuss theory: the emphasis is 100% on advice and suggestions reflecting best practice. The content will be accessible, clear and applicable in any commercial bank. All articles in each volume of Professional Perspectives will reflect a diverse global outlook, addressing issues of importance and relevance for all bankers.

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INVESTOR IN PEOPLE

Contents

Part II: Regulation and Risk Management

Part III: Best Practice in Interest-Rate Risk Management

Part IV: Trading and Relative Value Perspectives

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Peter Eisenhardt is the Secretary General of the International Council of Securities Associations, the global organisation of securities industry associations. ICSA provides a forum for member associations to exchange views and advocate appropriate regulations and initiatives across jurisdictions to promote efficient and well-functioning securities markets (www.icsa.global). He also acts as a consultant for leading investment banks and teaches courses in capital markets and asset liability management. Mr Eisenhardt has over 40 years' experience in banking. He was Head of Short-Term Fixed Income Origination at Bank of America Merrill Lynch in London. He worked for J.P. Morgan in New York, London and Tokyo in treasury, money market trading, bond options trading, repo, credit and origination. Mr Eisenhardt was voted by industry peers to Euroweek's 'Dream Team of the Global Capital Markets' in 2004. He is past chairman of the International Capital Markets Association Euro Commercial Paper Committee. Mr Eisenhardt holds a BA from Wesleyan University and an MBA from New York University.

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Claire Trythall is Head of Treasury Risk at Newcastle Building Society. She was previously Head of Asset-Liability Management at Hodge Bank and has held positions at Barclays Bank, Tesco Bank and Cumberland Building Society, within the fields of ALM and IRRBB. Claire has a first-class degree in Banking and Finance from the University of Derby, where she earned recognition as the Best International Business Student, and a Higher National Diploma in Business from Staffordshire University.

Preface

A warm welcome to this, the first hopefully in a series of volumes that will address current and emerging challenges and risks in the banking industry. The book's contents are directed at practitioners in banking; the ultimate aim is to encourage debate and discussion at bank boards and asset-liability committees (ALCOs) about how best to address current issues and, if deemed necessary, adjust strategies and business models so as to remain viable and relevant. It goes without saying then that the primary readership this series hopes to attract are senior executives and non-executives in banking.

We have assembled a diverse group of contributing authors, each of them recognised experts in their field, and all either current or recently retired bank practitioners. The chapters are divided into four parts.

Part I: Current and Future Challenges in Banking

In the first chapter, I consider current and emerging future challenges in banking. It being 2023, the implied question in the chapter title was put first to 'ChatGPT', an artificial intelligence (AI) programme that generated not inconsiderable comment and debate after it was 'released' to the world for use by essentially anyone. Our intention was to determine how effective, and genuinely practically beneficial, the output from ChatGPT was. The reader will draw their own conclusions, of course; ours was that (and only after a number of iterations) the effort of the AI platform merited, at best, a 'C+'. Our non-AI view considered that the challenges to all banks – whether traditional branch-based or newer digital 'challenger' or 'neo' banks – were many and varied, ranging from intense competition and geopolitical pressures to the better known ones such as liquidity risk and market risk. It was the latter, after all, that sunk one or two California-based banks in 2023, albeit in a slightly modified form aided and abetted by a new challenge, that of 'social media risk'.

In Chapter 2, Khaliq Ali presents a comprehensive discussion of strategic risk management in banks and how to approach it. As a risk type, it is recognised by the Basel Committee for Banking Supervision (BCBS) as one that banks should manage, but as Mr Ali states, 'Strategic Risk is [often] overlooked and is difficult to objectively quantify and manage…'. We hope his chapter helps to fill some gaps in this area.

Claire Trythall presents the first of two chapters authored by herself in this volume in Chapter 3. In an accessible account directed at asset-liability management (ALM) desks in banks, she recommends that ALM managers incorporate a number of key macroeconomic indicators when devising their approach to balance sheet risk management. And we do mean 'recommends' – there are 10 value-added recommendations articulated explicitly in this chapter.

Climate change risk management is a current important area of focus in banks, occupying the minds of everyone from the Board of Directors downwards. In Chapter 4, Miranda Love presents what may appear at first sight to be almost a polemic, but on closer reading shows clearly, almost self-evidently, that this is an area that banks all around the world need to take seriously, and not simply because of regulatory fiat. Edward Bace continues the environmental and sustainability theme in Chapter 5, where he discusses the value of including 'green bonds' in a bank's non-equity liability structure. As he suggests, there are sound reasons, both ESG and shareholder related, for doing so.

Part II: Regulation and Risk Management

In the second part of the book, we look at regulation and risk management. Fittingly, in the post-2008 crash era of ever more complex regulation and supervision, in the face of ever newer risk types, in Chapter 6 Graham Hillier goes 'back to basics' and emphasises that sound principles of traditional, and conservative, risk management in banking remain as important as ever. In essence, if one gets the basics right, everything else will fall into place.

That said, all practitioners in banking will know and appreciate that the industry is a heavily regulated one. Most banks around the world employ a team of people (this team can range in size from one person to several hundred people, depending on the size and complexity of the bank) engaged in what is termed as 'horizon scanning'. This simply involves watching out for the latest publication from the regulatory authority, dissecting it, disseminating it and suggesting how this regulation will impact the bank's operational procedures and risk management processes. These days, depending on one's jurisdiction, regulatory compliance occupies more senior executive time than any other single activity that said executive will undertake.

In light of this, we include two chapters that will assist the horizon scanning process. In Chapter 7, Peter Eisenhardt asks the question, 'Where are we going?' with regards to bank regulation. Periklis Thivaios then hints at an answer to this in the very next chapter. Following the publication by the Basel Committee for Banking Supervision (BCBS) of what is termed 'Basel III' bank supervision guidance in 2010, which was followed by the 'final form' of Basel III in 2017 (also referred to as 'Basel IV' or 'Basel 3.1'), he suggests that we are heading for 'Basel V'. All one can say at this stage is, watch this space!

In Chapter 9, Dr Andreas Ita looks at the lessons learnt for risk management from two recent market events, the default of Archegos Capital Management in March 2021 and the unusually large price jumps in energy markets in summer 2022. He finds that the counterparty exposure from margined derivatives transactions exceeded the required initial margin significantly in both cases, so that the exposures were largely uncollateralised when it mattered the most. In addition, the Basel Committee's Standardised Approach on Counterparty Credit Risk (SA-CCR) results in regulatory capital requirements that are insufficient to cover the banks' losses from the unwinding of large and concentrated derivatives exposures. This made it difficult for some banks to identify the high loss potential from their large trades with a single client. Dr Ita's chapter should be required reading for the Board members of banks that run large derivatives trading and prime brokerage operations!

Part III: Best Practice in Interest Rate Risk Management
When soliciting submissions for this book, we were intrigued by the number of authors who wished to cover interest rate risk in the banking book (IRRBB). Possibly this was due to the failure of Silicon Valley Bank, which some have suggested was due to poor (or non-existent, or incompetent – it depends whose views one deems to be the most accurate) IRR management. In any case, the number of chapters on this topic means the subject warrants a whole part to itself.

There are a number of facets to this discipline. Arnau Lopez kicks off in Chapter 10 with a high-level data analytics view, addressing the importance of good management information when addressing regulatory requirements for IRRBB. His chapter is of relevance to any bank, irrespective of size or balance sheet complexity.

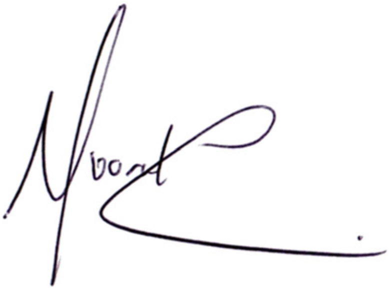
In Chapter 11, Beata Lubinska looks in detail at two particularly thorny aspects of the IRRBB discipline: how best to hedge 'pipeline risk' and 'prepayment risk'. Her chapter presents worked examples of the recommended approach to structural hedging of these risk types, which helps ensure that her text remains clear and accessible throughout.

Chapter 12 is the second of Claire Trythall's chapters in the book, and she also looks at prepayment interest rate risk in residential mortgage assets. However, she considers a specific approach to solving this conundrum, the 'rate incentive' method.

Patrick Carey rounds out Part III with a chapter that looks at the future of interest rate risk hedging. Considering the future challenges that face banks is clearly a common theme in this book! His chapter should be required reading for every bank's ALCO.

Part IV: Trading and Relative Value Perspectives
We thought we would leave the most technical and arcane subject for last! In Chapter 14, Trevor Pugh looks at the gilt futures basis. By this, we mean the UK Government bond market and the 'basis' (difference in price/yield) between the cash bond gilt and the exchange-traded bond futures contract. That one sentence may need explaining for some readers! However, when I first studied this subject, I found that getting to grips with the intricacies of the bond futures basis actually helped in understanding – properly understanding – many aspects of the wider financial markets. Mr Pugh does a fine job in taking the reader through the bond futures basis and explaining why it works as it does and how to interpret what the basis is telling us.

I enjoyed editing this volume, and I hope that you enjoy reading it. I also hope that readers find the contents to be of practical benefit in their 'day job'. Comments on the text are welcome and should be sent to the Editor via Emerald Publishing.



Professor Moorad Choudhry
Surrey, England
30th September 2023

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