



GLOBAL INDUSTRY SURVEY RESULTS 2011

# The Pace of Regulatory and Industry Change in Capital Markets

- A Survey by the Professional Risk Managers' International Association

June 2011

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**The Professional Risk Managers' International Association (PRMIA)** is a higher standard for risk professionals, with 60 chapters around the world and over 75,000 members from 198 countries. A non-profit, member-led association, PRMIA is dedicated to defining and implementing the best

practices of risk management through education including the Professional Risk Manager (PRM) designation and Associate PRM certificate; webinar, online, classroom and in-house training; events; networking; and online resources. More information can be found at [www.PRMIA.org](http://www.PRMIA.org).



## INTRODUCTION

It has been almost three years since risk management was thrust into the spotlight following the Lehman Brothers' default that sparked a global financial crisis. Once the inquiries into the causes of the crisis were complete, a raft of risk-based regulation was inevitable. Implementation timelines are now well established and financial institutions should be well on the way towards meeting their deadlines.

In order to ascertain both the level of preparedness and the accordance between the banking supervisors, such as the Basel Committee, and the risk managers they supervise, SunGard has teamed up with Professional Risk Managers' International Association (PRMIA) to produce its annual survey which addresses the four main areas affecting risk management – central counterparties; credit valuation adjustments; Basel rules and regulations; and the organization of risk management departments.

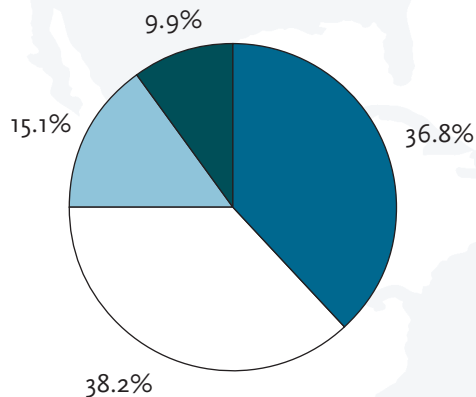
This is the third of such surveys to be run and it is possible to see clear signs of progress in terms of establishing the organizational framework needed to implement the various new regulations. And there is also evidence of a greater acceptance among risk managers of the need to make these changes and the likelihood of more successful risk management results.

But the survey also shows that consensus is far from unanimous on many issues, particularly those concerning Basel rules and the best way to organize a risk management department.

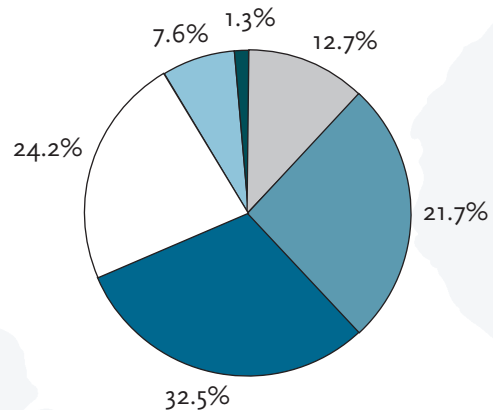
## SECTION 1 – CENTRAL COUNTERPARTIES (CCPS)

This section asked about respondents' views on central counterparties and how effective they might be. The majority of participants felt that CCPs will not change the overall volume of derivative transactions they are undertaking, although roughly one third said the mix of business would change. When asked to estimate the proportion of derivatives that will be centrally cleared, the view was markedly higher than last year, with the highest response moving from the 10%-24% bucket to the 25%-49% bucket.

### How will the introduction of Central Counterparties impact your business?



### What proportion (by number of contracts rather than notional) of OTC do you think will be cleared by Central Counterparties by the end of 2013?



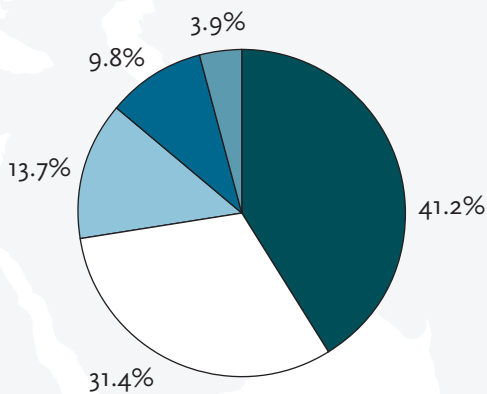
- We will do fewer derivatives transactions overall due to CCPs
- CCPs will not affect our business
- We will do roughly the same volume, but the mix will change
- We will do significantly more derivatives business due to CCPs

- < 10%
- 10 – 24%
- 25 – 49%
- 50 – 74%
- 75 – 90%
- > 90%

## SECTION 2 – CREDIT VALUATION ADJUSTMENT (CVA)

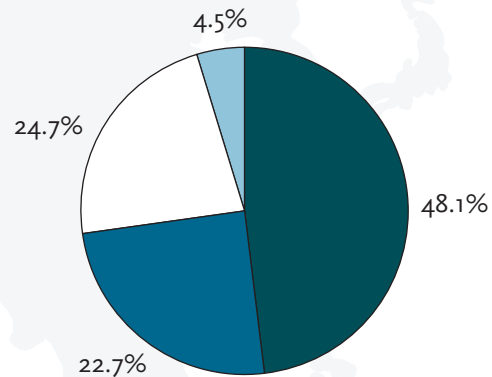
CVA continues to be seen as an important trend in the market place, albeit in most cases it is in the early stages of active management. 72.6% of respondents said they either do not measure CVA, or measure it for finance/accounting purposes only. This illustrates that for the majority of firms, CVA remains outside the daily risk management processes. There has been significant progress in terms of implementing CVA calculations, with the number of firms reporting that they have nothing in place dropping from 62% last year to 49% this year, and the number of firms reporting they have a live system leaping from 20% last year to 28.5% this year. Finally, despite the move to centrally cleared derivatives, the majority of respondents (56%) thought that CVA remains more important than ever in managing a firm's credit risk.

### How is Credit Valuation Adjustment (CVA) viewed:



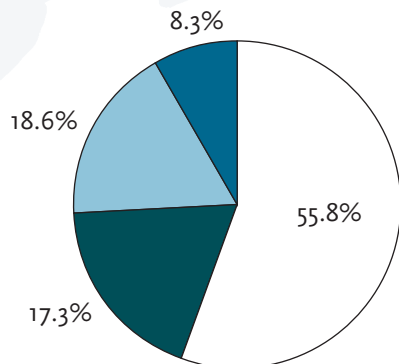
- We do not measure CVA
- We only measure CVA for accounting/finance purposes
- We actively manage and hedge our CVA exposures
- We measure CVA daily and allocate to the business
- We measure CVA intra-day for pre-deal credit pricing

### Many institutions are looking to implement CVA calculations. How far is your institution in this process?



- We have nothing in place at present
- We have begun implementing CVA but are not live
- We have a live CVA system but it needs further changes
- We have a live CVA system which does everything we need

### With the rise in central clearing, is it possible that credit metrics such as CVA will become less relevant?



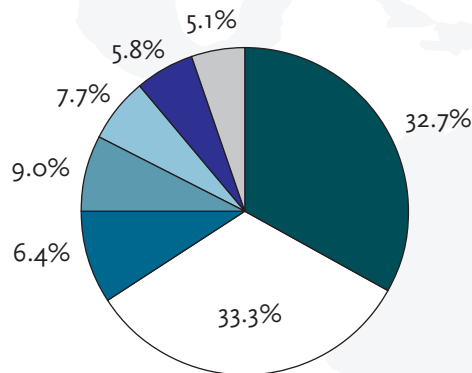
- Margin calculations are more important than longer-term metrics
- The non-cleared derivatives will be the complex ones, so CVA is more important than ever
- The pressure is off improving credit risk management
- The shift to CCPs makes no difference

## SECTION 3 – BASEL RULES AND REGULATIONS

The Basel rules suggest several ways to improve the overall robustness of banks' risk management practices, and our survey shows a mixed bag in terms of progress towards these. There were little signs of progress towards the monitoring of wrong-way risk, or in putting credit backtesting systems in place. However, there was solid progress in the area of stress testing, with a drop from 35% last year to 22.5% this year saying they have no credit stress tests currently in place, and a leap from 28% last year to 47% this year of people reporting monthly or better credit stress tests. Another area of progress was in reverse stress testing, where we again saw a significant drop in the number of people saying they have no reverse stress tests in place (down from 57% last year to 47% this year), and an almost doubling from 8% last year to 15% this year in the number of people who have reverse stress tests as an integral part of their stress testing regime.

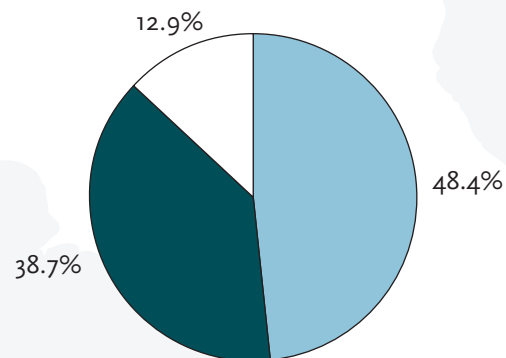
When asked about the greatest challenge to meeting the new rules, the most significant change from last year was a jump from 11% to 16% in people citing business realignment, showing that the new capital charges are going to affect the business model of many institutions going forward.

**The Basel committee states there are shortcomings in how the industry measures and monitors wrong-way risk. Please select the statement you most agree with:**



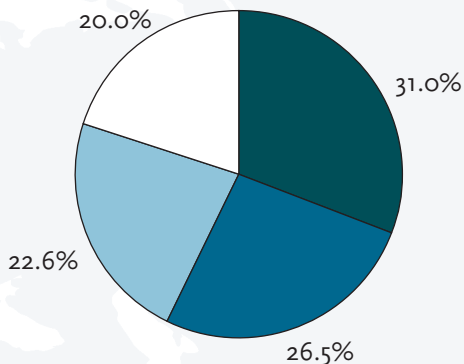
- We do not actively monitor wrong-way risk at present
- We monitor certain instances of wrong-way risk on a manual basis
- We have a system in place to automatically flag instances of wrong-way risk based on static identifiers
- We have a system in place to automatically flag instances of wrong-way risk using a stress-testing approach
- Wrong-way risk is incorporated into our economic capital model so we do not monitor it specifically
- Wrong-way risk is incorporated into our economic capital model and we also monitor it separately
- We specifically measure wrong-way risk, quantify it and include it in pricing decisions

**Credit Backtesting was identified as one area that needs further work at many institutions. Please select the statement you most agree with:**



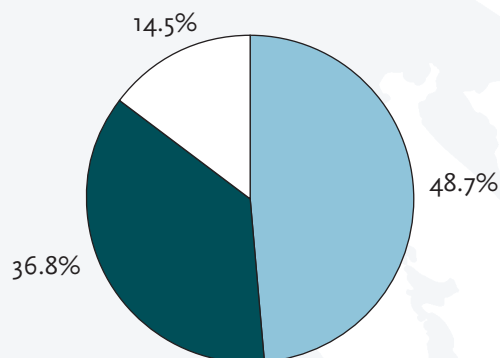
- We currently have little or no backtesting in place for our counterparty credit models
- We have piecemeal backtesting of parts of the process
- We currently run regular and robust backtesting for our counterparty credit

Greater emphasis is to be placed on stress testing. Please select the statement you most agree with:



- We do not currently have credit stress tests in place
- We run credit stress tests quarterly or less frequently, and the tests tend to remain static
- We run credit stress tests monthly or more frequently, and the tests tend to remain static
- We run credit stress tests monthly or more frequently, and the tests are reviewed quarterly or more frequently

The Basel committee recommend banks undertake reverse stress testing to identify extreme scenarios. Please select the statement you most agree with:



- We do not currently perform reverse stress testing
- We undertake reverse stress testing on a ad-hoc basis
- Reverse stress testing is an integral part of our current stress testing regime

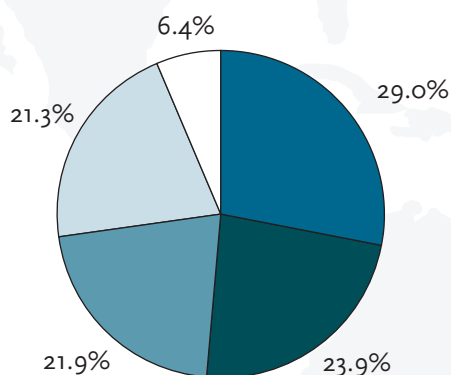
## SECTION 4 – STRUCTURE OF ORGANIZATION

When asked about the state of their collateral management departments there was a general increase in the overall level of satisfaction, with 22% saying they need no major improvements (up from 15% last year). The most popular response was still that there is a need for investment in both systems and staff, although the number dropped from 37% last year to 29% this year. Interestingly, the number of people saying they do not have a dedicated collateral management function doubled from 11% last year to 22% this year. This ties in with the general market trend of linking collateral and funding functions to give an enterprise view of all collateral, unencumbered assets and margin requirements, and 38.4% of people agreed that all financial collateral should be managed centrally, with a further 28% wanting to bring banking book collateral into the picture.

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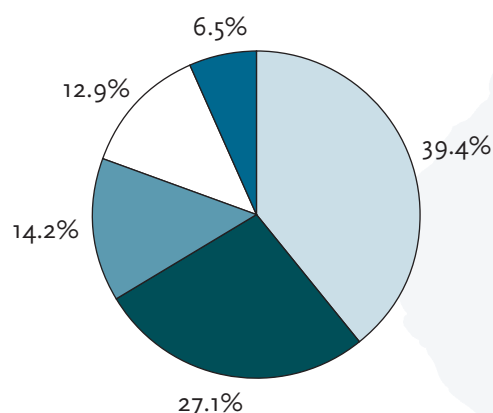
Moving to the structure of credit and market risk we see that there are still many banks that treat these two disciplines separately. Fully 34% of people state that they have separate credit and market risk departments with separate systems, and a further 36% have one department but still separate systems. This leaves 30% of firms where either models, or the complete systems, are common across credit and market risk. In terms of independence from the front office, over 60% of risk management departments have their own models for credit and market risk, with 22% having separate models for credit but sharing front office models for market risk, and just 17% reusing front office models for both credit and market risk purposes.

**Some regulators have expressed significant and general concerns about most collateral management activities. They recommend that banks enhance the operational performance of the collateral department. Please select the statement you most agree with:**



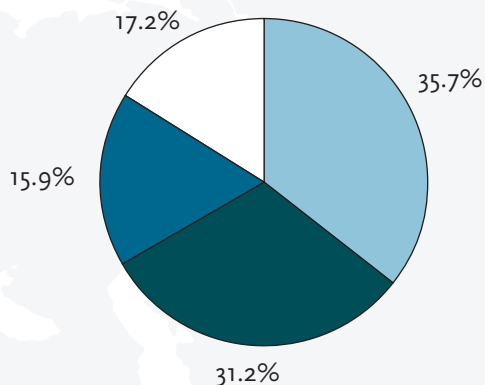
- We need both more staff and an investment in systems
- We have adequate staff, but our systems need more investment
- We do not have a dedicated collateral management function
- Our collateral management department performs well and needs no major improvements
- We have adequate systems but we need more staff

**Many institutions view collateral in silos. How far should cross-silo collateral management and optimization go?**



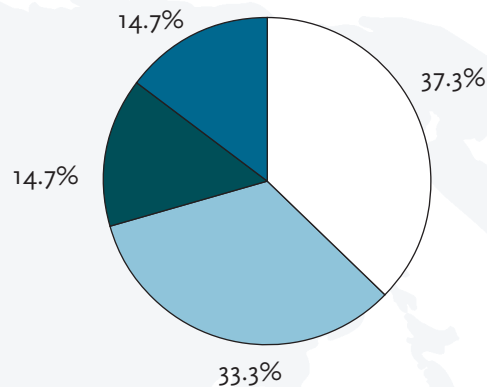
- All financial collateral should be managed centrally
- All collateral, including banking book collateral should be pooled and managed centrally
- OTC and Exchange Traded Derivatives should share systems and processes
- Continue to manage in individual silos
- OTC and Securities Financing should be managed together

**What do you expect to be the greatest challenge in order to meet the latest regulatory proposals relating to counterparty credit risk:**



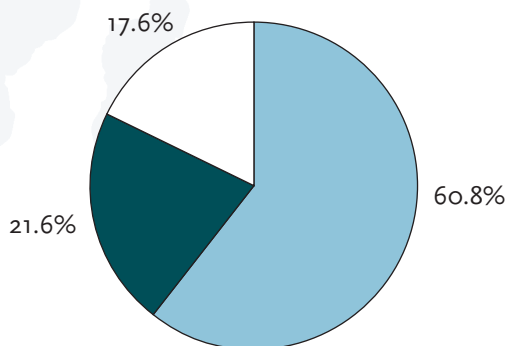
- Technology
- Data gathering and calibration
- Risk manager's expertise (need for training, recruitment)
- Business realignment (towards less capital-intensive activities)

**How does your institution manage market and credit risk?**



- We have one risk department but separate systems for credit and market risk
- We have separate departments with separate systems
- They are separate departments with separate systems, but share common models
- We have market and credit risk on one technology platform

**How independent are your risk models (valuation and portfolio) from the front office?**



- Risk management have their own models for credit and market risk
- Risk management have their own models for credit risk and use front office models for market risk
- Risk management use front office models for both credit and market risk

## EXECUTIVE SUMMARY

The 2010 PRMIA/SunGard survey showed that there was no clear consensus on almost any aspect of the Basel Committee's recommendations, a range of opinion on how effective the introduction of CCPs would be, and a lack of uniformity on the level of preparedness among banks for implementing proposed changes.

Fortunately, the 2011 survey shows some progress has been made, even if this is mostly a greater acceptance of the inevitability of the regulatory changes rather than a whole-hearted embrace of their intentions. For example, there was an increased expectation that a larger proportion of OTC derivatives will be centrally cleared.

And the over-riding message from many banks as regards credit valuation adjustments seems to be the recognition that it is important even if there were not yet live systems in place to manage it, which shows banks are moving from the 'talking about it phase' to putting systems in place.

Such an inference supports the concluding remark of the 2010 survey – that even those banks with a low level of resources and unsophisticated system must accept that compliance is mandatory and they would be best served by getting their compliance projects started rather than debating the points of policy. At this stage it is no longer about fairness but about feasibility.

The questions regarding the Basel rules showed little change from 2010 other than clear advances in the implementation of a solid stress-testing regime. The most profound discovery from the survey responses was the fact that 'business realignment' was cited as the biggest concern as regards Basel rules.

This suggests that the majority of banks are now fully involved in implementation projects and are beginning to see the effects new capital adequacy rules will have on the bank's business model. It also suggests that the effects of Basel rules are now being discussed at a wider level within banks rather than solely the compliance or risk management departments.

The findings of the 2011 survey suggest that organizational changes to risk-based functions are likely to be the main area of interest in next year's survey. Now that most banks' compliance projects are fully underway, the economic cost will be hard to ignore and banks would be well advised to examine what organizational changes can be made to both lessen the cost of compliance and maximize its internal benefits.



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