Chapter 16
Strategic Decision Making and Risk Management in the EU

Imre Sabahat Ersoy
Marmara University, Turkey

ABSTRACT

Innovative managerial thinking in global business economics necessitates the follow-up of the developments in the international regulatory framework of risk management for strategic decision making. The risk management framework which evolved from Basel I to Basel III (or with the December 2017 finalizations, the way the market calls it "Basel IV") in the world economies and Capital Requirements Directive (CRD) V and Capital Requirements Regulation (CRR) II in the European Union have been game changers. Global managers need to take strategic decisions in this new international risk management setting in order to succeed in the competitive global business environment. For effective capital management, risk function and finance function should come together. For effective implementation, this mix should be supported by establishing partnership among the risk, finance, and strategy groups.

INTRODUCTION

Basel Committee on Banking Supervision (BCBS) of Bank for International Settlements (BIS) headquartered in Basel is set up by G-10 Central Bank governors in 1974 for international supervisory and regulatory harmonization. Basel framework is not binding but forms the basis for rulemaking. The doubts about the health of international banks after the failure of Herstatt Bank coupled with the complaints about unfair competition led BCBS to develop Basel Capital Adequacy Accord (Basel I) in 1988. Basel I capital was insensitive to risk and was seen as part of financial reporting and away from strategic risk management. Basel I, which has been phased in by 1992, introduced risk weights for the G-10 internationally active banks. The simple and transparent Basel I which focused solely on credit risk is updated in 1996 to include market risk. The standard method for market risk was risk insensitive whereas the Value at Risk (VaR) model for market risk management became risk sensitive. Yet, as suggested by Ozdemir (2018) "In this period, the risk and finance functions worked largely independently and there

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was not much of an attempt to integrate and co-manage the entirely risk insensitive regulatory capital and the risk sensitive, but unproven and difficult to understand, economic capital."

BCBS started discussing Basel II in 1999 and finalized it in 2004. Basel II revised the credit risk framework, kept the market risk component as it is and introduced operational risk. Basel II within its three pillars structure relied heavily on self-regulation with internal models developed by banks; introduced the supervisory review process and disclosure requirements. Basel II compared to Basel I is much more complex and more risk sensitive. The required capital under the Internal Rating Based Approach (IRBA), particularly the Advanced IRBA became risk sensitive. But the risk function lacked the integration with the finance and strategy functions (Ozdemir, 2018).

Basel III, introduced in 2010 is the end result of the global financial crisis and has been implemented since 2013 and will be fully implemented by 2019. The crisis showed that banks had too little capital, too little liquidity but too much debt and not enough equity, that is to say too much leverage. Basel III increased both the minimum capital level and the quantity of capital to make sure that capital was loss absorbing in order to prevent bank runs. Basel III also included Liquidity requirements like Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). Basel III, with a view to enhance firmness of the financial structure targeted systemic risks in terms of macro-prudential measures, introduced leverage backstop, countercyclical capital buffer, and higher capital requirements to Systematically Important Institutions (SIIs). Basel III also extended disclosure necessities under pillar III to empower market discipline. The Capital Requirements Directive (CRD) IV and the Capital Requirements Regulation (CRR) which transposed Basel III into EU legislation entered into force on July 2013, applicable since January 1st 2014. The main result of Basel III was the decline in loans due to high credit and liquidity requirements.

The finalized Basel III- which is named Basel IV by the industry- introduces Capital Floors; recommends a new Standardised Approach (SA) to interest rate risk capital management; makes proposals for simplification of the Operational Risk, the revision of the SA and IRB Approach of Credit Risk, Market Risk with a fundamental review of the trading book (FRTB), Securitizations framework, and the SA for measuring counterparty credit risk exposures (SA-CCR). Basel IV also includes regulatory adjustments like the introduction of IFRS 9 accounting standards.

Capital Requirements Directives (CRDs) are parallel initiatives in the EU to the Basel Framework. On November 2016 the European Commission (EC) launched CRD V and CRRII. CRD V and CRR II will enter into force earliest by 2019. With CRR II the EC has translated global regulatory accords into EU law.

Starting with Basel III, the strategic risk management has evolved. "… The risk function's involvement in setting up the optimization framework and determining optimal risk strategies within this framework, subject to the organization's risk appetite constraints, takes the role from traditional risk compliance to strategic risk management, from being effective brakes to a co-pilot in determining corporate strategy." (Ozdemir, 2018)

The paper is motivated, to the best knowledge of the author, by the void of a through analysis of the CRD V and CRRII with its affects within the overall Basel framework in the literature. The rest of the chapter is organized as follows: Section 2 reviews the Basel I, Basel II and the initial plus the finalized Basel III frameworks. Section 3 examines particularly the implementation phases of CRD V and CRR II. Section 4 scrutinizes the possible impacts of CRD V/ CRR II on EU banks. Finally, section 5 concludes.