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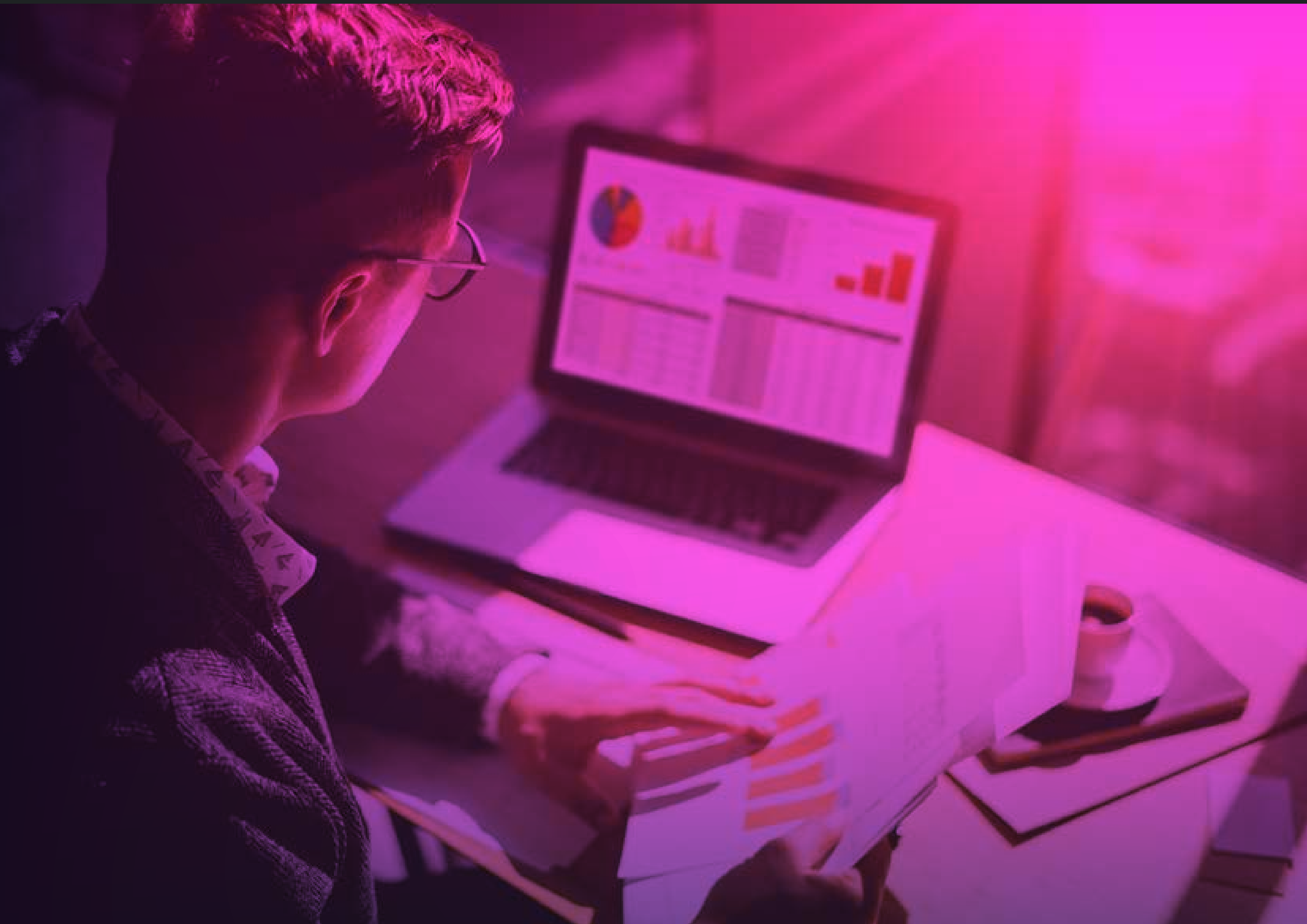
RWA Optimization: The Path to Efficient Capital Management in Banks



Abstract

For banks, the COVID-19 crisis has translated into a rise in loan loss provisions and increased risk-weighted assets (RWA) resulting in depleting returns and capital ratios. Governments, regulators and banks globally are resorting to a host of measures to stimulate economies, help businesses stay afloat, and manage the work-from-home culture, all while trying to minimize risk. This also requires building a resilient bank that can navigate through the low profitability environment while minimizing impact on capital. This can be accomplished by building counter cyclical provisions out of profits in a benign environment or maintaining higher capital than the minimum regulatory capital. It is also crucial to manage the risk of being over-capitalized as banks with excess buffers can potentially compromise returns and hurt investor sentiment.

Chief financial officers (CFOs) of banks are expected to strike a fine balance between achieving optimum growth, while maintaining an appropriate level of risk, and maximizing returns within the various constraints imposed by capital availability. As capital is the costliest form of funding, it is not easy to come by or recover, if lost. Therefore, CFOs need to strengthen their buffers to manage risks through capital management. This white paper throws light on the various avenues that banks can explore for augmenting capital.

Strategic Levers for Capital Management in Banks

With stringent regulatory requirements for ensuring capital adequacy in banks, CFOs need to manage and improve decision-making in areas such as liquidity, asset-liability management and capital planning. Efficient capital management mandates a measured approach to deployment by maintaining a diversified book with strong capital levels and taking timely decisions on capital infusion, quantum of capital to be raised, allocation, and monitoring its usage. However, with the banking industry already facing undercapitalization driven by regulatory requirements and volatile financial markets, achieving such a balance is not easy. Higher loan provisioning and counterparty risks will increase the credit risk weighed assets, thereby impacting capital adequacy ratio, which can be improved either by raising capital or ensuring efficient capital utilization.

RWA optimization is one of the low hanging fruits that can ease the burden of capital management in banks. Theoretically, RWA calculations and reporting can be as straightforward as a mathematical calculation. However, poor RWA models, inefficient management of data flowing into the models, and incorrect implementation have undesired effects on RWA calculation. It is therefore important to improve the RWA calculation accuracy to free up capital. As there is human judgement involved in deciphering the intent of the regulations, it is good practice to

check what peers are doing. For instance, banks can benchmark model output against independent models available in the market. Some measures that could improve the accuracy of RWA (especially credit risk RWA) calculations include:

Enable effective inter-department collaboration

With disconnected and fragmented departments, processes and technology, teams operate in silos with little transparency on end-to-end processes. While risk teams own the responsibility of calculating capital requirements based on stipulated regulations, operations teams are instrumental in static data maintenance, which is a prerequisite for ensuring efficacy of the RWA computations. Similarly, business and finance teams are responsible for ensuring accurate data capture of trade economics. However, capturing all fields of static customer data correctly in the system is crucial to ensure that right data flows to the RWA computation engine. Incomplete customer data capture might lead to the exposure being disqualified from the advanced approach calculation, and potentially attract 100% risk weight by default. This requires higher levels of capital — a fact which data-capturers are mostly unaware of. Banks must arrest such leakages with structured processes and right controls within teams that manage know-your-customer (KYC) records, onboarding, credit risk management, and operations. This enables accurate data capture and subsequent maintenance, in turn enhancing profitability.

Release capital from areas of inefficient use

Committed credit lines attract RWA — even the undrawn ones. Hence, reducing limits on credit lines (or making them uncommitted until further notice) for customers that do not generate enough returns or consistently underutilize their limits can enable capital optimization. In addition, pricing generally includes a risk premium, it helps improve risk adjusted returns while product reviews and benchmarking help optimize capital and resource allocation. For instance, benchmarking can help understand if the product has generated the desired return on capital. If not, any incremental allocation of capital can either be restricted or completely withheld, and diverted to products that exceed the threshold criteria.

Identify and fix leakages from poor data linkages

Poor collateral capture, calculation, and linkage practices have a detrimental effect on capital planning. It not only impacts capital adequacy in banks but is also costly given the need for manual patching of RWA processes resulting in heavy personnel costs and even regulatory fines in case of serious issues. Periodic reviews to identify potential gaps in collateral calculation and linkages can help mitigate such damaging effects. Banks can map end-to-end processes to highlight cases of non-fulfillment of qualitative criteria resulting in potential losses. One way to do it is to undertake remediation efforts for getting unrated counterparties rated (especially in cases where ratings might help reduce the risk weights to free up capital).

Tighten capital allocation process for future growth

Capital allocation is a risk management tool that can serve the twin purposes of boosting current business and fueling future growth by enhancing capital efficiency and optimized risk adjusted performance. Analyzing risk-adjusted returns can help with holistic relative performance measurement across different businesses. To arrive at decisions such as restructuring, downsizing or exiting low paying businesses and pave the way for capital re-allocation to business lines earning threshold hurdle rates, banks must assess the capital consumed relative to returns.
In addition, banks must switch from the traditional capital allocation approach to a progressive process covering the planning period whereby the risk appetite can be allocated to various business divisions. This can be done by putting in place a framework to periodically evaluate the risk-adjusted returns for each business and accordingly reallocate capital during the course of the year to ensure productive deployment.

Release capital through sale of exposures

Capital can be released by selling the regular advances to other banks or institutions (to de-risk the balance sheet). This option is largely used by the banks during stress scenarios or a tight liquidity situation wherein other investors might be open to taking on higher risks in anticipation of higher returns. Typically, smaller banks use this option to raise funds by selling their advances to larger banks or state-owned banks. It is therefore important to factor the cost component as well, and ensure any decision in this regard is weighed against the longer-term strategy.

Suspend capital pay-outs

To shore up the capital base and survive the crisis in the short run, banks need to retain their earnings by suspending dividend pay-outs or buy backs. In a business-as-usual scenario, the pay-out ratio is defined by dividend policy, however in stressed times, exceptions need to be made and efforts directed at raising or conserving capital.

Optimize expenses to strengthen capital base

As growth takes a backseat and revenues shrink in the ongoing crisis, it is imperative that CFOs take a hard look at optimizing operating expenses to reduce the pressure on the bottom line. As net profit directly adds to the bank's capital base as retained earnings, banks need to negotiate vendor and rental services and revisit terms and conditions of contracts with vendors and service providers while postponing big ticket expenditure to bolster their capital base.

Leverage technology to boost decision-making

The growing complexity of banks' balance sheet is further compounded by an intricate and intertwined technology landscape. CFOs today need reliable, accurate, and timely information in the form of both internal data (daily liquidity positions and risk profiles) and external data (real-time credit spreads and market liquidity) to take the right decisions. In addition, process-mining tools can help enable bank transformation via process redesign. With regulators putting unprecedented emphasis on data quality, straight-through processing, and minimal manual touch points, banks must build an agile technological landscape and evolve at a pace faster than ever before.

In a Nutshell

CFOs need to be agile, brutally transparent and act decisively by embracing a forward-looking approach to brace themselves for continuous turbulence and uncertain situations that may arise. Strengthening the capital base is the only booster dose for banks to navigate economic catastrophes and emerge stronger and more resilient. RWA optimization offers a way to quickly free up capital and banks that kickstart RWA initiatives will ensure efficient capital management and seamless business operations in volatile times thereby stealing a march over the competition.

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Nidhi Samdani is a senior business consultant with the CFO Strategic Initiatives group in the banking, financial services, and insurance (BFSI) business unit at TCS. She has nearly 18 years of experience in financial planning and analysis (FP&A) primarily in business performance management. She is a key member of the team bringing thought leadership to assist clients in their transformation journey. Nidhi is a qualified chartered accountant from the Institute of Chartered Accountants of India (ICAI).

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