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Compliance and Control 2.0

Unlocking potential through compliance and quality-control activities

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Compliance and Control 2.0: Unlocking potential through compliance and quality-control activities

From the periphery to the center

In recent years, with the increased awareness that operational and control failures can be extremely costly, banking compliance and quality control has become much more relevant to senior executives. Greater business complexity has introduced new compliance challenges that have been augmented by formal regulatory requirements.

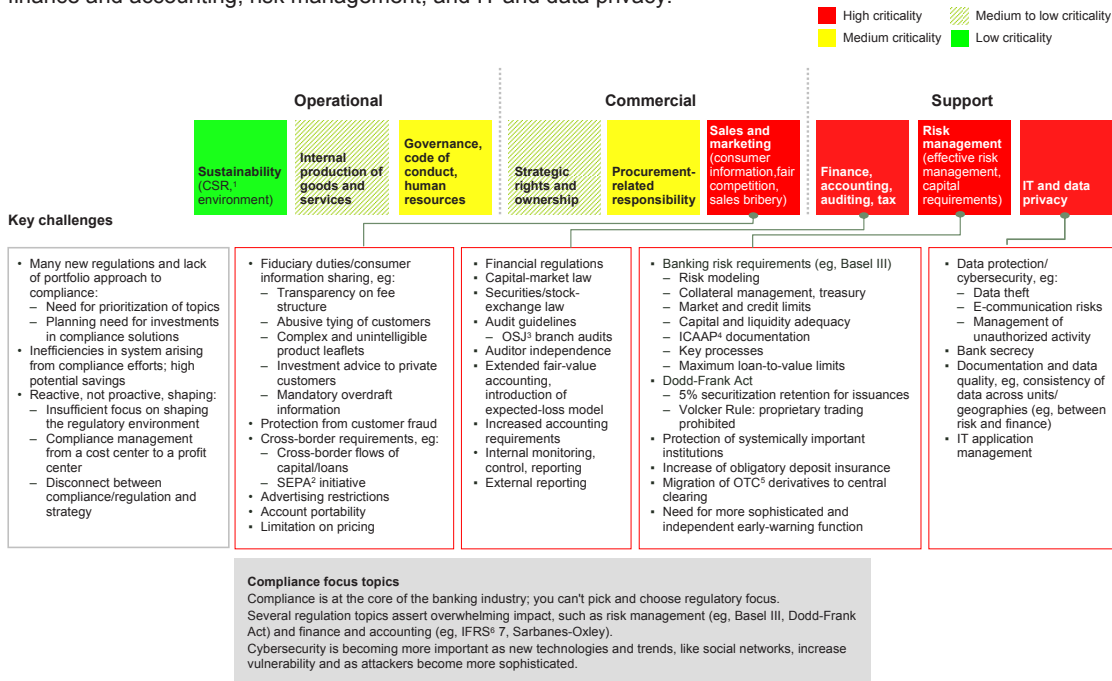
The established role of compliance and control to simply observe laws and follow regulations is now being replaced by an integrated, much broader view on requirements and standards necessary to conform to. Compliance requirements increasingly derive from emerging industry standards, internal business or ethical guidelines, or awareness of reputational risks; they also derive from transparency requirements and assurance of quality and control of governance, processes, methods, and IT or infrastructure in such critical areas as risk and finance. In particular, we observe “ex post compliance failures” in banking, that is, personal liability for actions that were viewed as standard market practices a few years ago, but carry compliance relevance today, for example, with regulatory capital relief trades. Exhibit 1 provides an overview of the key areas of compliance and control across banking institutions.

In addition, the task of compliance and control today has become much more complex for institutions that have far-reaching global footprints and therefore face myriad local laws, regulations, supervisory authorities, cultural differences, languages, time zones, and so on. We estimate that an effective compliance and control system consumes three to five times (in some cases, even more) as much profit as it did 10 years ago. On the other hand, noncompliance or control failures due to limited management transparency or insufficient quality control of governance, processes, or systems have become much more expensive than in the past. Board directors and top management face increasing levels of personal-liability risk and fines. Failures often result in high media attention and costly damage to corporate reputations that have been earned over decades of hard work. Noncompliance or control failures can also lead to significant loss of core-client business, distract senior management from their task of running the business and focusing on clients, and produce depressed stock-market valuations. This can, in turn, impose substantial, even existence-threatening costs.

Furthermore, the challenges imposed on compliance by a broader range of relevant requirements, standards, and guidelines and increasing business complexity have been amplified by tightening regulatory supervision. In particular, various regulatory bodies at national and international levels have responded to the financial crisis by issuing a barrage of new rules and by continuing to tighten and more comprehensively audit existing requirements. For example, increasing consumer-protection regulations, introduced by the Dodd-Frank Act in the United States and by EU-wide rules, as well as national rules, are having a major impact, creating an imperative for retail banks and financial institutions that sell investment products to reengineer their compliance efforts. Although many of the proposals, such as the new Basel III regulations, are still under discussion, it has become clear that banking institutions will face significantly stricter and more extensive regulation, as well as more intrusive supervision in the future. Also, many regulators and supervisors are beginning to impose their own interpretations of specific rules and regulations. Their intention is to set minimum standards across the industry and, in certain areas, to define “market best practices” as experienced or perceived by the supervisory authority. For example, we observe regulators across the board now employing Pillar 2, especially the Internal Capital Adequacy Assessment Process (ICAAP), to accelerate the formal timeline for key capital requirements set by Basel III. This “informal” regulation is likely to continue to grow in importance.

Exhibit 1 Critical areas of banking compliance and control include sales and marketing, finance and accounting, risk management, and IT and data privacy.

NOT EXHAUSTIVE



1 Corporate social responsibility.

2 Single Euro Payments Area.

3 Office of Supervisory Jurisdiction (US Securities and Exchange Commission).

4 Internal Capital Adequacy Assessment Process.

5 Over-the-counter.

6 International financial reporting standards.

Compliance and control review: A missed opportunity

We believe it is high time for leading global financial institutions to undertake a comprehensive assessment of their compliance efforts in regard to (expected) regulatory requirements and to review in detail the quality control for core processes, governance, and infrastructure. The success of such initiatives will have an important impact on future performance because the implementation of new requirements and quality control demands an ever-increasing share of management attention and bank resources. Banks should see this review as an opportunity to articulate clear expectations and behavioral guidelines for their employees and to define the quality and integrity of products and services they offer to their customers. We think that institutions with superior approaches can convert this investment into sustainable and formidable competitive advantage.

However, too often the knee-jerk response to increased regulation or to errant behavior is to introduce more bureaucracy—another set of “essential” operating checklists or, worse, another layer of control leading to duplication of functions across the organization. Compliance and quality control that is aimed purely at satisfying the letter and not the spirit of the regulation will fail to make the material improvements intended to strengthen both the banking institution and the industry as a whole.

We call this “blind compliance and control”; recent observations indicate, troublingly, that it appears to be on the rise. This form of compliance and quality control is characterized by the following developments:

- A multitude of overlapping, poorly structured, and even inconsistent rules, regulations, and guidelines that are often difficult to read or understand
- Requirements without a clear purpose and intention
- Requirements that exist only on paper and are either not ingrained or are poorly applied in the institution
- Rules, regulations, and guidelines that are perceived as red tape, a distraction from core tasks, and a cost or tax, instead of as a source of value

Ironically, an increase in the number or the stringency of policies, especially when these are detached from the realities of the business, may actually increase risks as employees resort to ticking boxes without reflecting on the intention behind the rule and the potential danger of noncompliance for the institution.

Sample tests assessing the material effectiveness of some of the most important regulations often return poor results. At one large European bank with external regulatory requirements for an early-warning system and a “watchlist” process with clear handover criteria for the workout unit, those critical risk-management elements only existed on paper. The early-warning system was revealed to be rudimentary at best and substandard compared with those of competitors. Additionally, the handover criteria were not widely known, or they were ignored. All these revelations came as a shock to senior management, not only as a compliance failure but also as a business failure. At another large regional bank, a comprehensive self-assessment unearthed systematic inconsistencies between the credit-risk strategy and the overall business strategy, leading to unwanted exposures with negative risk surprises.

Our recent observations also suggest that while many risk-management departments are struggling to focus on managing and controlling risks, they instead end up overstressing to close audit points, implement new regulations, and satisfy ad hoc reporting requests. Similarly, many banks lack basic clarity as to who in the organization is actually responsible for compliance. In a typical organizational structure, compliance might be an independent governance unit sitting alongside internal audit and legal units, but not operationally connected to the risk-management function, IT, operations, and other key areas that are in effect performing compliance and control activities, including the frontline business. Just as appointing a chief risk officer can induce in nonrisk staff a more casual attitude about taking responsibility for risk, having a chief compliance officer, as many banks do, also can lead to an institution taking a narrow view of compliance and control and failing to appreciate its broader importance. Compliance, just as risk management, must become an institutional capability, not just an organizational unit.

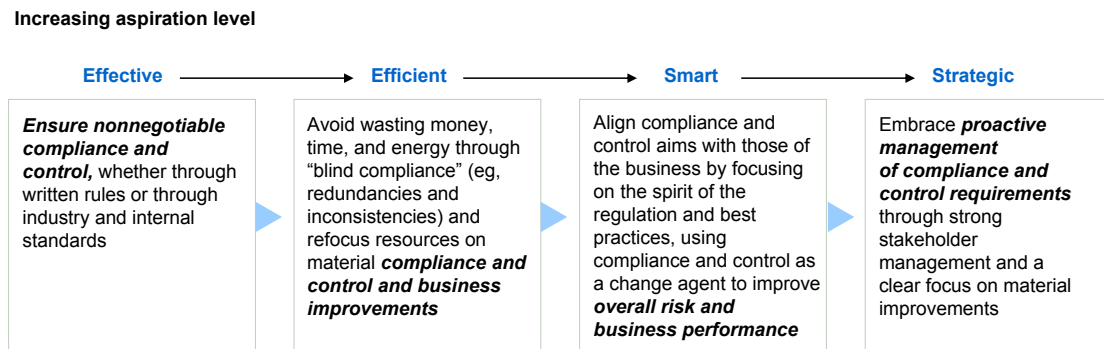
It would be a mistake, however, in our view, to see the underlying intentions of lawmakers, regulators, and supervisors as being anything other than an effort to ensure the sustainable development of both individual banks and the industry as a whole. More often than not, the spirit of rules, regulations, and guidelines mirror those good intentions. However, for banks to benefit from the overall imposition of regulation, it is vital to capture that spirit rather than getting lost in the letter. The same holds for quality control. It is hard to argue against assuring a sufficiently high quality of governance, processes, methods, and IT or infrastructure, especially concerning critical areas such as risk management. But how is it possible to ensure that those activities result in maximum material improvements? How can regulation and quality control be seen as an opportunity to catalyze change and promote excellence that ultimately leads to sustainable competitive advantage?

We believe that, given this backdrop, the time is ripe for a fresh look at compliance and quality control. In the following sections, we outline a new and systematic methodology that institutions can use to transform their compliance and quality-control activities, positioning these activities to become a true source of strength and sustainable competitive advantage.

Toward Compliance and Control 2.0

In our view, effective compliance and control requires an explicit strategic consideration, the ultimate goal being compliance and quality controls that are not only effective but are also efficient, smart, and ultimately able to add strategic value (Exhibit 2). Avoiding the trap of blind compliance and control and focusing instead on transforming a perfect regulatory storm into an opportunity to create competitive advantage will require a systematic, disciplined, and somewhat innovative approach.¹

Exhibit 2 Compliance and Control 2.0 aspires to add strategic value.



Our approach is deceptively simple and becomes even more so after its initial implementation. It effectively transforms compliance and control activities from distracting chores into opportunities to redefine business excellence in a systematic way. The central idea is to take compliance and control back to the basics, to the conscious decision to adhere to sensible practices, rules, and regulations that serve as the foundation for safe and sound business conduct. The approach focuses on material process and infrastructure improvements, and on the spirit, rather than the letter, of regulation. This allows for significant improvements in effectiveness and efficiency, as well as smart alignment with business objectives. Furthermore, the approach offers an ideal platform for strategic shaping of the requirements through proactive stakeholder management with industry bodies, regulators, and supervisors, as opposed to waiting for supervisors to hand down detailed requirements.

Conducting a four-step self-assessment

Compliance and Control 2.0 starts with a comprehensive mapping of all market best practices, as well as regulations and guidelines, both external and internal, that the financial institution intends to comply with. Even “informal” regulation in the form of oral regulatory requests or audit findings from regulators, auditors, or internal audit can be included. Then management makes a conscious decision and commits to *how* the institution wants to comply. This is followed by a decentralized self-assessment to understand the gap between what the institution intends to achieve and what it had implemented before these *internally defined* targets can be reached and to identify the root causes.

¹ This paper is part of a broader initiative, the Compliance service line, which cuts across industries and geographies.

Four-step approach

With respect to this comprehensive map of practices and regulations, hereafter simply referred to as “requirements,” we have developed a four-step approach.

1. The first step is to design a target compliance system by analyzing the requirements topic by topic and item by item to create full transparency, and then to summarize them in an annotated version for further use. The process is multipronged:

Management should develop a clear understanding of the underlying rationale, the spirit, or the original intention of the requirements.

- Why does each element of this set of requirements exist?
- How does this support a sounder and safer business?
- What material improvement is the requirement intended to make?

Next, it collects market best practices in this area (minimum standards necessary for regulatory compliance, as well as industry standards and leading practices that can constitute a competitive advantage).

In light of the requirements’ rationale and market best practices, management must make conscious strategic decisions and define how the institution would like to comply with the requirements.

This initial step is a critical point at which senior management can define the staff’s desired behavior and the institution’s level of aspiration. It also allows management to take an integrated view of compliance and control, considering business and strategy angles and identifying inconsistencies and weaknesses.

2. In a second step, the organization conducts an organizational self-assessment on compliance and control. The annotated version of the requirements is used to develop a questionnaire that assesses current levels of compliance. This set of questions is mapped into the organizational landscape (for example, to determine who inside the organization is affected by or responsible for compliance, control, and management for particular items or topics). The individual questionnaire is then sent out to the responsible managers, who are asked to assess the level of compliance and provide evidence of compliance (for example, written documentation, regular self-audits, and descriptions of current practices). The completed questionnaires and supporting evidence are collected and compiled into a compliance library. The assessment phase is finalized through a central control and validation process. Exhibit 3 provides an example of the design of a self-assessment questionnaire.
3. The target compliance system and the results of the self-assessment are used to identify gaps and define the measures necessary to close them. For example, a global universal bank that applied the self-assessment approach found that its early-warning system for single corporate exposures was inadequate, even falling short of certain regulatory requirements. The identified gaps and defined measures provide senior management

Exhibit 3 A central control and validation process helps complete the assessment phase.

EXAMPLE

	Self-assessment by responsible manager			Evaluation of self-assessment through PMO ¹		
	G	A	R	1	2	3
	Full compliance	Compliance only partial/meaningful exceptions	Noncompliance	No issues	Adjustments/deep-dive analysis recommended – No formal noncompliance – Certain risk of general audit points	Adjustments/deep-dive analysis highly recommended – Likely to lead to noncompliance audit findings
				Adjustments/deep-dive analysis absolutely necessary – Clear and severe breach of regulation – Will almost certainly lead to material audit findings		

	Topic	Requirement	Reference to regulation	Assessment		Comments/issues
				Self	Review	
Governance/strategy	Credit-risk strategy	Consistency of credit-risk strategy (also with business strategy)	Based on ...	G	2	Consistency of credit-risk strategy with business strategy ensured? Process to ensure consistency?
	Organizational structure responsibilities, personnel requirements	Appropriate level of risk staff qualification/experience Separation of front office and trading areas from risk (independence principle)	Based on ...	G	1	

¹ Project-management office.

with an overview of the most important deficiencies so leaders can make final recommendations on mitigating actions. It is critical at this step to have an open discussion with management and experts across divisions on the root causes of deficiencies that have been discovered and the defined measures to refine and create buy-in across the organization (not only in the risk and compliance departments). For example, senior management at one global universal bank found out that limit management was materially impaired because it was impossible to aggregate exposures across units in a timely fashion as a result of data-quality issues triggered by insufficient interfaces of different IT systems. Only analyses and cooperation across the different divisions owning the IT systems made the identification and eventual resolution of this deficiency possible.

- The fourth and last step is critical to ensure that improvements are made on a sustainable basis. This includes offering education and training and making cultural changes, as well as turning the first comprehensive compliance and control effort into a continuous compliance and quality-improvement program. A cyclical approach that repeats the self-assessment, for example, on an annual basis, can be a useful way of assessing the effectiveness of implementation and preparing for new or emerging regulation. The final step, therefore, is the enhancement and streamlining of associated questionnaires and processes as preparation for the next round.

It is vital that the core analysis and decision steps (steps one and three) are performed by working groups that include representatives and experts from relevant units of the bank, including, for example, front-office units. This has the benefit of ensuring that informed decisions are made with the knowledge and experience of those directly affected. This group dynamic also creates early buy-in from the broader organization, thereby helping to *embed* compliance and control into the daily routines of the organization's employees.

In some cases, the preferred solution may deviate from the letter of the external regulation. In these cases, discussion and clarification with the regulator or supervisory authority is required. If an element is internal, the solution is, of course, much easier. In either case, the resulting annotated version of the requirements can play an important role when managing stakeholder interactions.

Closing the gaps

After the self-assessment has unearthed all gaps and their root causes, a systematic effort should be launched to close those gaps and address the underlying causes. This effort comprises three distinct elements:

- **Project-organization and milestone plans to close all identified gaps.** For each identified gap, a plan is designed to close the gap, with clearly defined milestones, timelines, and responsibilities. Gaps are bundled in workstreams, typically aligned with the organizational setup of the financial institution. The workstreams report into a central project-management unit, which is responsible for stringent milestone and project-execution tracking, removal of roadblocks, and the facilitation of cooperation and exchange across divisions or functional units.
- **A program to optimize certain shortcomings in the overall governance and organizational setup.** A review process evaluates the financial institution's performance with respect to the quality of processes, methods, IT and infrastructure (for example, data quality), and compliance. For instance, is there an independent unit within the bank or for each division with a direct reporting line to the executive board that systematically reviews and ensures compliance? How well are audits performed (that is, with sufficient know-how, frequency, scope, and depth)?
- **A review of the underlying risk culture of the financial institution.** We have observed in many financial institutions that certain elements of the inherent risk culture are at the heart of why there are systematic quality deficiencies, failures, or blind compliance and control. This has been extensively addressed in an earlier working paper.²

Compliance and control as a change agent to drive competitive advantage

Compliance and Control 2.0 offers a set of distinct advantages over other, more auditing-intensive compliance approaches:

- It ensures *transparency on strengths and weaknesses* across the institution and emphasizes *groupwide quality control and compliance*, thereby building awareness of dangerous blind spots.
- It has a *clear focus on material improvements* for the institution, for example, allowing regulation and compliance to work as a change agent in support of bankwide gains.

² Eric Lamarre, Cindy Levy, and James Twining, "Taking control of organizational risk culture," McKinsey Working Papers on Risk, Number 16, February 2010, www.mckinsey.com.

- It *creates buy-in and support for improvement initiatives* across the organization and turns energy and resources that would have been wasted on blind compliance and control into material improvements and excellence.
- It *addresses the root causes* of systematic deficiencies, failures, and quality issues by focusing on best practices and the spirit—rather than the letter—of regulatory requirements, as well as by explicitly including adjustments to the overall governance, organization, and risk culture of an institution.
- It *demonstrates an active managerial approach and can substantially reduce the time and effort* needed to deal with external audits and regulators or auditors, freeing up resources that can be deployed into other productive activities.

The first and most important element of Compliance and Control 2.0 is the *level of transparency* it creates throughout the organization. This is due to the decentralized process that allows simultaneous assessment of quality and compliance across all areas and units of relevance. Individual managers typically know and understand their own areas best and can therefore discover quality deficiencies and noncompliance issues more reliably and efficiently. This places the responsibility for effective compliance and quality control directly in the hands of those experts and managers who are best positioned to make the assessment if they are given the right questions. Due to the independent central validation of the results, management has sufficiently strong incentives to apply the right level of candor, effort, and rigor to the self-assessment. Of course, executing self-assessments and self-audits in a culture where there is no fear of errors helps. If institutions find this difficult, temporary amnesties comparable with those used to pull “black” money back into the legal monetary systems could be used: for instance, “if you disclose now during the self-assessment where the gaps are, it will be treated as a positive contribution to excellence; on the other hand, those discovered later on will be viewed as conscious deceit.”

The methodology has a *clear focus on material improvements* with operations, processes, procedures, practices, and performance firmly in its sights. Compliance and Control 2.0 avoids rules and regulations being taken as given, but rather creates a platform for the discussion of regulation. In particular, it facilitates discussion about how best to comply and, when necessary, how to revise regulation to allow material improvements to be captured affordably.

Through its collaborative self-assessment approach, Compliance and Control 2.0 *creates buy-in and support for improvement initiatives* across the organization. Relevant areas of the organization are deeply involved at the initial stages of setting target best practices, interpreting regulation, and thus defining how to comply. Then, during the audit phase, management has the opportunity to internalize the audit process, rather than being audited by an external authority. Management or relevant experts essentially step into the shoes of auditors (and regulators), thereby fundamentally changing their perception of the audit process. Finally, the approach ensures maximum buy-in for the potential action program: those who have helped to discover the gaps in their own area of responsibility are able to help define and implement solutions.

Compliance and Control 2.0 *addresses the root causes* of systematic deficiencies, failures, and quality issues by focusing on best practices of regulatory requirements. The approach explicitly includes a discussion and action program during the implementation phase around shortcomings in the organization’s overall governance and risk culture, thus bringing any systematic issues to the surface.

Compliance and Control 2.0 *demonstrates an active managerial approach and can substantially reduce the time and effort needed to deal with external audits and regulators or auditors.* The thorough and rigorous self-assessment approach helps to enhance best practices. It also demonstrates several things to potential external auditors: how seriously the institution takes quality control and compliance with regulatory requirements; how systematically and thoroughly the institution strives to achieve high-quality governance, processes, methods, IT, and infrastructure in critical areas and in compliance; how focused the institution is on achieving maximum material improvements; and how much effort and resources have been invested to achieve this. The documented results of self-assessments can be used as an excellent starting point for external audits.

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