Outline

1. Introduction -
   » Definition
   » Importance
   » Contributing Factors: GFC

2. Focus on risk: where we are internationally (SIE, FSB peer review)

3. Focus on Risk: Basel Committee Update - Corporate Governance Principles for Banks

4. Word about Risk Appetite / Culture

5. WB Bank Governance Reviews – Overall Observations
Corporate Governance Defined

Corporate governance is the system by which companies are directed and controlled

... a set of relationships between a company’s management, its board, its shareholders...

... provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined

Source: Sir Adrian Cadbury, UK Combined Code; OECD Corporate Governance Principles, 2006
Importance of governance in banks

**Vulnerability of banks**
- Banks are in the business of intermediation of risk. The inherent nature of the banking business makes them more vulnerable.
- Consequently, there is a greater need for better governance practices at banks.

**Systemic significance**
- Failure of a bank has a systemically larger impact – contagion effect on firms and other banks.
- Banks act as the fulcrum of payment systems and default can lead to failure of multiple financial institutions.
- Multiplicity of stakeholders - Depositors, Borrowers, Employees, Community, Regulators, Government...
- Banks = “special interest entities”

**Economic impact**
- Banks generate a multiplier impact on the economy – their role as fund providers is crucial for ‘money transmission’.
- Bank distress, failures bring disrepute to the economy and erode country’s global standing.
- Bank failures have a debilitating impact on economies - Case in point: Japanese bank failures in the 1990’s; GFC 2007/8.
Overarching observation of the SSG:

Weaknesses in governance, incentives, and infrastructure undermined the effectiveness of risk controls and contributed to (2008) systemic vulnerability

- Unwillingness or inability of boards of directors and senior managers to articulate, measure, and adhere to a level of risk acceptable to the firm
- Arrangements that favored risk takers at the expense of independent risk managers and control personnel,
- Compensation plans that conflicted with the control objectives of the firm, and
- An inadequate and often fragmented infrastructure that hindered effective risk identification and measurement
Governance Role in Global Financial Crisis
(Senior Supervisors Group Report, 2009)

- Disparity between the risks that their firms took and those that their boards of directors perceived the firms to be taking
  - Insufficient evidence of active board involvement in setting the risk appetite for firms in a way that recognizes the implications of that risk taking

  Boards didn’t understand the risks being taken by management

- Rarely did supervisors see firms share with their boards and senior management:
  - Robust measures of risk exposures (and related limits)
  - The level of capital that the firm would need to maintain after sustaining a loss of the magnitude of the risk measure, and
  - The actions that management could take to restore capital after sustaining such a loss

  Effective boundaries for risk taking not set in advance
Governance Role in Global Financial Crisis
(Senior Supervisors Group Report, 2009)

10 critical areas for continued improvement

- Board and Senior Management Oversight
- Articulating Risk Appetite
- Compensation Practices
- Risk Information Technology Infrastructure
- Risk Aggregation & Concentration Identification
- Stress Testing
- Credit & Counterparty Risk Management
- Valuation Practices
- Operations & Market Infrastructure
- Liquidity Risk Management
The GFC evidenced many examples of **cognitive failure at the Board level**

**Bottom line:**

Risk governance challenges for Boards are complex & formidable

In particular, defining risk appetite – putting effective boundaries around the forward-looking risk profile, and how it can evolve through time - is one of the most difficult risk governance challenges.
Focus on Risk: Supervisory Intensiveness and Efficiency of SIFIs (systemically important financial institutions)

A key mandate of the FSB, it issued a report on the intensiveness and effectiveness of SIFI supervision (the “SIE Report”) on November 1, 2010.

The FSB SIE Group issued a follow up report Oct 2011 that reviewed supervisory and firm progress:

- Effective risk appetite frameworks (RAF) that are actionable and measurable by both firms and supervisors are not yet widely seen.
- Supervisory expectations for controls are rising but one area – the risk management function at SIFIs – was still not be considered strong.
- More intense supervisory oversight is needed to evaluate the effectiveness of improved corporate governance, particularly risk governance.
Focus on Risk: Supervisory Intensiveness and Efficiency of SIFIs (systemically important financial institutions) (cont)

• Many firms had made progress in conceptualizing and articulating a risk appetite statement; however, supervisors observed few changes in risk culture.

• While progress was being made at both the supervisory and firm levels toward strengthening the CRO’s organisation, most were not yet considered strong.

The 4th recommendation in the 2011 report directed a FSB Peer review on risk governance
Focus on Risk: FSB Third Thematic Peer Review – Risk Governance (February 2013)

Progress post crisis: (Supervisors)

- Developed or strengthened regulation / guidance
- Elevated supervisory expectations for risk management
- Engaging more frequently with board and management
- Accessing adequacy / accuracy of board information
Progress: Firms in regions hardest hit by the crisis have generally made the most progress in strengthening risk governance.

- Assessing collective qualifications and effectiveness of boards (self evaluation or third party review)
- Making significant progress in strengthening composition of board
- Establishing Risk Committee with independent directors & defining independence
- Establishing group-wide CRO and risk mgmt function with independence and authority
- Integrating discussions between risk & audit committees
Issues Cited:

• Authorities do not engage frequently enough with boards, risk and audit committees

• Elevation of the role of the CRO needs to be further supported by the risk committee through reviewing performance and setting objectives, ensuring fluid access to the risk committee and board (in-camera sessions with non-executives)

• More developed objectives, procedure for risk committees

• More work required (by authorities and firms) on establishing integrated risk appetite framework (RAF)

• No jurisdiction has specific expectations for internal audit to perform firm-wide assessment of risk mgmt / governance

• CAE (chief audit executive) requires more access to full board (and in-camera sessions with non-executives)
Consultative document for the update of the 2010 Corporate Governance Principles, October, 2014, to take account of FSB findings & other pieces of work:

- Explicitly reinforces the risk governance responsibilities of the board
- Emphasizes key components of risk governance: risk culture, risk appetite, and their relationship to a bank’s risk capacity
- Delineates specific roles of the board, board risk committee, senior management and the control functions including the CRO and internal audit
• Principles should be applied commensurate with the size, complexity, structure, economic significance and risk profile of the subject bank and the financial group (if any) to which it belongs.

• SIFIs to have in place corporate governance structure and practices commensurate with their role in and potential impact on national and global financial stability

Jurisdictional differences:

• Different terminology and structures – Board and senior management; one-tier/ two tier structures; executive and non-executive positions

• Applicability of national laws
The updated Principles reinforce the board’s ultimate responsibility for:

- the bank’s business strategy and financial soundness
- corporate culture and values
- key personnel decisions, internal organisation and governance structure and practices
- risk management and compliance obligations
- overseeing the implementation of key policies pertaining to the bank’s capital adequacy assessment process, capital and liquidity plans;
- requiring that the banks maintains a robust finance function responsible for accounting and financial data
- approving the annual financial statements and periodic review of critical areas;
BCBS Corporate Governance Principles for Banks – board function

In addition, the Board should take an active role in developing the risk appetite:

• Risk appetite development may be initiated by senior management (CRO)
• BUT successful implementation = effective interactions between the board, senior management, risk management and the business line (+ CFO) (top down / bottom up)
• Risk appetite should align with bank’s strategic, capital and financial plans and compensation practices
• Board should oversee adherence to the risk appetite statement, risk policy and risk limits
BCBS Corporate Governance Principles for Banks – board function

Risk Appetite Statement:

• Qualitative + quantitative elements
• Define boundaries & business considerations when implementing bank’s business strategy
• establish individual & aggregate level and types of risk in advance of positioning that risk
• Enumerated risk appetite < bank’s risk capacity
  (i.e. that level of risk that the bank could take based on regulatory, capital, and risk management parameters)
• Communicated throughout the institution
Three Lines of Defense:

1. Business Line
2. Control functions – risk management, compliance, financial control / operations
3. Internal audit function
### 3 lines of defense framework

**... who is responsible for careful risk management?**

<table>
<thead>
<tr>
<th>Governing Body/ Boards (Oversight)</th>
<th>1st line of defense</th>
<th>2nd line of defense</th>
<th>3rd line of defense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sets the ‘Tone at top’, risk culture</td>
<td>“Owner” of risk taking activity</td>
<td>Oversees risk taking activity</td>
<td>Independt assurance on quality + effectiveness of intl control, RM, compliance function, governance systems</td>
</tr>
<tr>
<td>Establishes risk appetite and strategy</td>
<td>Assesses, manages, &amp; reports / communicates risk levels &amp; issues</td>
<td>Assess risk independently from business line</td>
<td>Validates the overall risk framework, quality of risk reporting to board</td>
</tr>
<tr>
<td>Approves the risk governance framework</td>
<td>Activity consistent with conveyed risk appetite, controls, limits, policies</td>
<td>w/approval from board, deploys the overall RM frmwk incl. systems, policies, models</td>
<td></td>
</tr>
<tr>
<td>leverages risk information into decision making process.</td>
<td>Reflects institution’s risk culture through activity</td>
<td>Supports risk appetite development + translates to limits</td>
<td></td>
</tr>
<tr>
<td>Evaluates BU activities on a risk adjusted basis</td>
<td></td>
<td>Articulates and reports risk material, aggregate, and emerging risks</td>
<td>Reporting only as good as the underlying analysis</td>
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</table>

*1st and 2nd line need robust risk profiles*
Principles reinforce independent risk management function under the direction of a Chief Risk Officer (CRO)

- **Responsibilities**: overseeing risk activities across the enterprise with sufficient authority, stature, independence.
- **Activities**: identify, assess, measure, and monitor aggregate and emerging risks; develop & implement enterprise-wide risk governance framework (incl. risk culture, risk appetite, risk limits); establish system for limit / risk appetite breaches; influence / challenge material risk decisions; reporting
- **Independence** (no “dual hatting”) & and relationship with business line
- **Adequate resources**, budget, staffing, training
Includes:

- Expanded discussion on CRO responsibilities *(inter alia)*:
  - Ongoing strengthening of staff skills
  - Enhancing RM systems, policies, processes, quantitative models, reports to support risk taking activities
  - Supporting Board in its oversight of development of risk appetite and the RAS **
  - Supporting Board in its oversight of translating the risk appetite into risk limit structure **
  - Managing & participating in key decision making processes (strategic planning, capital / liquidity planning, new products, compensation design / operation) **
  - Ability to articulate, interpret risk and effectively interface with business, board, management **

- CRO appointment, dismissal, change of position
  - Should be approved by Board / RC
  - Performance, compensation, budget reviewed & approved by Board / RC
A Word about Risk Appetite

- Risk Appetite is both qualitative and quantitative.
- Developing a Risk Appetite framework is a multi-year, iterative “journey”, which is quite new for most firms – many of which are still in the relatively early stages.
- The cultural, procedural & technical challenges involved in defining risk appetite are formidable; the process is complex, requiring interaction between Board, senior management & risk management, and a substantial amount of time and judgment.
- Nevertheless, this is indeed achievable - some leading firms are making very good progress, and seeing clear benefits already, including a clearer understanding of the risk implications of strategy & business plans.
- A strong “Risk Culture” is an essential component of, and a pre-requisite to, establishing an effective Risk Appetite framework.

A Word about Risk Appetite cont.

- Risk Appetite must be tightly and formally linked to strategy development and business planning, to ensure alignment.

- Firms have adopted a wide range of approaches in developing their Risk Appetite frameworks, reflecting their diverse business models, infrastructure, capabilities & circumstances (clearly visible in the case studies and report text):

  “one size does not fit all”

- Risk appetite needs to be intimately bound up with corporate culture, corporate governance, strategy and planning, as well as risk. It takes time, with a good deal of trial and error, to introduce an effective framework. There are few templates and “one size does not fit all”.

- Supervisors must view and evaluate risk appetite established by a bank / bank group flexibly.

- The degree of progress varies – a substantial gap is likely to remain for some time between emerging good practices & what is more “typical” across the industry.

A Word about Risk Culture

Central elements of an effective risk culture include

- Horizontal information sharing
- Vertical escalation of threats or fears
- Continuous and constructive challenging of the organization’s actions and preconceptions
- Committed leadership
- Incentives that reward thinking about the whole organization

Establishing a strong “risk culture” is of paramount importance in ensuring effective risk management – and a CEO & Board responsibility

- Most important determinant of risk management effectiveness?
- Impossible to know everything about emerging risks & rapid changes to bank’s risk profile through formal channels (committees, risk reports, etc.)
- “Informal” channels for information are essential
- To effectively balance risk & return at every level, banks should:
  - Deliberately create environment that encourages dialogue about risk
  - Make it safe for employees to question/challenge/escalate things that they don’t understand, and then reward this behavior …
  - This is absolutely essential, in order to ensure that bad news travels upwards quickly, but extremely difficult to do

“Risk culture” is the responsibility of the Board, CEO and leadership team – the CEO must lead by example, continually emphasising the importance of properly discussing and understanding risks, and encouraging employees to debate and “speak up”...

Overall Observations in WB client countries (Bank Governance reviews conducted in 15 countries)

- **Lack of objectivity** (independence) of board and separation of functions ((controlling) ownership, oversight, mgmt) impacts recognition for need of strong risk governance / management

- **Board performance evaluations** – relatively infrequent

- **Understanding of role** of board – risk governance responsibility; lack of input in strategic planning; lack of risk planning

- **Risk committee** – increasingly common but need defined role; MIS

- Need for **formalization of risk mgmt**; establish CRO role, define independence (removing from business line); authority; skills; resources (substantially lacking); access to risk committee and full board; input into “risk strategy” – prospective risk profile

- Very few if any **independent assessments of risk governance** framework; few RAFs (risk appetite framework) begun

- **CAEs** require more fluid access to full boards and in-camera sessions with non-executive board members
THANK YOU