Risk Reward riskupdate

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New Standards for Risk Management

Also in this issue

RISK BASED CORPORATE GOVERNANCE – THE NEW BIS PROPOSALS

Dennis Cox is the Chief Executive of Risk Reward Ltd, the Global Risk Forum and chairs the Chartered Institute of Securities and investment Risk Forum based in London. In this article he briefly reviews the new Corporate Governance paper issues for comment by the Bank for International Settlements

The Bank for International Settlements have just issued a new paper entitled "Principles for enhancing corporate governance" for comment by 15 June 2010. These build on the Organisation for Economic Co-operation and Development (OECD) principles published in 2004 which were republished by the BIS in 2006.

The principles are as follows:

Principle 1

The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The Board is also responsible for providing oversight of senior management.

Principle 2

Board members should be and remain qualified, including through training, for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank.

Principle 3

The Board should define appropriate governance practices for its own work and have in place the means to ensure such practices are followed and periodically reviewed for improvement.

Principle 4

In a group structure, the board of the parent company has the overall responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities.

Principle 5

Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board.

Principle 6

Banks should have an independent risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board.

Principle 7

Risks should be identified and monitored on an ongoing firm-wide and individual entity basis, and the sophistication of the bank's risk management and internal control infrastructures should keep pace with any changes to the bank's risk profile (including its growth), and to the external risk landscape.

Principle 8
Effective risk management requires robust internal communication within the bank about risk, both across the organisation and through reporting to the board and senior management.

Principle 9
The board and senior management should effectively utilise the work conducted by internal audit functions, external auditors and internal control functions.

Principle 10
The board should actively oversee the compensation system's design and operation, and should monitor and review the compensation system to ensure that it operates as intended.

Principle 11
An employee's compensation should be effectively aligned with prudent risk taking; compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment.

Principle 12
The board and senior management should know and understand the bank's operational structure and the risks it poses (i.e. "know-your-structure")

Principle 13
Where a bank operates through special-purpose or related structures or in jurisdictions that impede transparency or do not meet international banking standards, its board and senior management should understand the purpose, structure and unique risks of their operations. They should also seek to mitigate the risks identified (i.e. "understand-your-structure").

Principle 14
The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

What does this all mean?
We have 14 new principles which the BIS are proposing and these do collectively bring into the regulations the idea of risk based corporate governance. They are looking for subsidiary boards to take ownership of their risk profiles and do such actions as are necessary to meet these obligations.

The skills of Boards are now designed to operate individually and collectively, with risk management applied globally and at entity level. The underlying objective is to make sure that the board understands its structure and that it is sufficiently transparent with its disclosure such that market participants also have the necessary appreciation of the risk profile.

And then of course there are the compensation requirements. By seeking to align the remuneration with prudent risk taking the regulators are seeking to reduce risk in the banking industry. Of course this will always be an objective – there can be no benefit to regulators in encouraging risk taking. What should have been required would be for the strategy and goals of the institution to be aligned to appropriate risk taking in a form acceptable to the regulatory authorities. Measuring the divergence from the goals and missions would be the key to the level of additional risk being undertaken as a result of the individual work being conducted.

It is in the assessment of the risk reward relationship, together with the introduction of risk mitigation, which would lead to a sensible conclusion. However the focus on prudent risk taking may lead to a reduction in the risk appetite within firms – and a deleveraging of the global economy.

This is another of those requirements which, whilst reasonable in theory is likely to have unforeseen consequences. A reduction in risk taking may lead to certain market dislocations and a reduction of liquidity. This in turn complicates the development of appropriate yield curves, resulting in greater uncertainty and a consequent increase in risk. The conundrum is that the rules would then continually enforce risk reduction to the stage at which is disappears altogether.

Are these a good set of rules or not? I do hope that they are read and the 40 pages considered appropriately. From our point of view the general governance principles or risk based corporate governance are broadly welcomed. However the compensation parts of the paper are a greater concern and, hopefully, will eventually be tempered in their enthusiasm.

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