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New Standards for Risk Management

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NEW STANDARDS FOR RISK MANAGEMENT (PART 1) – GOVERNANCE AND RISK CULTURE

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 first in a series of articles on this subject he proposes what he believes are the new standards for risk management in light of the plethora of recent reviews and papers generated by international regulators, national governments and the banks themselves.

Background

On 16 February 2010 the Committee of European Banking Supervisors (CEBS) issued their High Level Principles of Risk Management. This followed the declaration of the G-20 leaders on 15 November 2008 to "develop enhanced guidance to strengthen institutions' risk management practices, in line with international best practices, and encourage financial firms to re-examine their internal controls and implement strengthened policies for sound risk management."

As a result of conducting a gap analysis and developing a road map, the CEBS identified the following gaps that required addressing:

1. **Governance and risk culture**
2. **Risk appetite and risk tolerance**
3. **The role of the Chief Risk Officer and risk management functions**
4. **Risk models and integration of risk management areas; and**
5. **New product approval policy and process**

Of course only some of these were actually related to the crisis and as with any series of rules development the opportunity has been taken to look at a range of issues. In this series of articles we will look at some of the key elements of these new principles.

Governance and Risk Culture

The Risk Culture

The principles state that "A strong institution-wide risk culture is one of the key elements for effective risk management. One of the prerequisites for creating this risk culture is the establishment of a comprehensive (covering all risk types, business lines and relevant risks) and independent risk management function under the direct responsibility of the Chief Risk Officer (CRO), or the senior management if a CRO is not appointed, following the principle of proportionality."

So what actually is a risk culture and how can one be created? Can you just buy one from a consultancy firm? We often get asked to provide a standard version of a document that can be tailored to any bank – in this case no such document can really exist. A risk culture is driven from the tone of senior management and inculcates all of the employees and operations of the bank. It is all embracing and drives behaviour.

From our point of view it drives from the Goals and Missions of the firm and sets out the parameters within which risk management operates. The risk culture is higher level than individual risk elements and needs to be applied across the entire profile of the bank's risk framework. Are there any risks where the risk culture is not relevant? I cannot think of any – any risk can be transformed, controlled, accepted or mitigated. Accordingly we view the risk relevant test as being relevant to the bank.

We would expect all banks to have appointed someone as Chief Risk Officer even if that role were in some cases combined with other responsibilities. This will be addressed in more detail in a later article.

The Management Body

In paragraph 10 the paper states that "The management body is responsible for overseeing senior management and also for establishing sound business practices and strategic planning. It is therefore of the utmost importance that the management body in carrying out both its management and supervisory functions has collectively a full understanding of the nature of the business and its associated risks."

This is particularly interesting and does represent a challenge for some risk management functions. Sound business practices are often under the responsibility of the business unit, with compliance responsibility sitting with some form of compliance officer. The paper appears to envisage the risk management function becoming involved in this area. We would expect this to be limited to ensuring that the right issues are taken into consideration by the compliance function, together with the maintenance of adequate evidence to support the decisions taken. Whether the risk management function could effectively veto what they consider to be an unacceptable business practice is rather a different issue.

Strategic risk management is always an interesting area. In many firms strategic risk does not fall within the ambit of risk management. When implementing an enterprise risk management solution the inclusion of strategic risk into the risk framework is clearly important. The broader requirement on knowledge and understanding is a collective rather than an individual responsibility as currently drafted. That is an interesting approach and raises issues regarding whether there needs to be a balance of understanding between the executive officers and the non-executive officers.

To be able to demonstrate that these requirements had been fully met would require both a detailed report being provided to the Board, together with evidence of the discussions that take place being minuted. It is not in our opinion sufficient to just table the risk profile – there needs to be actual scrutiny and the engagement of both executive and non-executive officers is crucial.

Personal Responsibility

The following paragraph (Para 11) requires that "Every member of the organisation must be fully aware of his responsibilities relating to the identification and reporting of relevant risks…"

Within the Basel framework for banks opting for the advanced measurement approach with regard to operational risk, all staff members may have received training regarding the identification of operational losses. Hopefully in many firms there will be complete risk registers dealing with all risks throughout the bank, although in many cases these exist within risk management and deal primarily with operational losses.

The requirements here go much further and appear to require risk training to take place throughout an organisation. From our experience such training tends to be limited to higher level operational and risk management employees and management. Clearly anyone in a business can incur or identify a risk and indeed it is people that actually do things that are most likely to result in additional risk being incurred. The development of training programmes, regularly reinforced by case studies examples and communication from above, that apply to all employees is therefore required. Many staff will understand little regarding risk and wonder why it applies to them – training will need to be innovative, practical and broadly based to meet these requirements.

It will be interesting to see how many firms actually choose to train all of their employees, which attempt to rely on documents being distributed and which train only senior staff hoping for a trickledown effect.

In future articles we will look at the other issues in this important (and mercifully short) paper.

For further information please contact:

Dennis Cox – CEO
telephone: +44 (0)20 7638 5558
email: DWC@riskrewardlimited.com

Lisette Mermod – New York
telephone: 1-914-619-5410
email: LM@riskrewardlimited.com

Joanna Kraska – Public Relations
telephone: +44 (0)20 7638 5558
email: JK@riskrewardlimited.com