Risk Reward
riskupdate
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The Basel Committee

A REVIEW OF THEIR ANALYSIS OF THE TRADING BOOK QUANTITATIVE IMPACT STUDY

BANK FOR INTERNATIONAL SETTLEMENTS

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WHEN THEY CALL YOU – WHO ARE YOU GONNA CALL?

A RISK PRACTITIONER'S GUIDE TO MAKING GOOD CREDIT RISK MANAGEMENT HAPPEN

Mary Phibbs, ACA, a Chartered Accountant, has held Group Chief Credit Officer and other senior credit and risk management positions at ANZ Standard Chartered Bank, KPMG, PWC, National Australia Bank and Commonwealth Bank of Australia and is passionate about credit and risk management. She is adept at explaining and sharing practical understanding, project management and change management solutions when charged with rolling out a credit risk programme within a bank. Mary contributes this as the first in a series of articles for risk practitioners whose role is to embed sound credit risk governance and practice in their organizations.

You are the Head of Risk or Chief Credit Officer for a medium to large sized Financial Institution and so far you have done a great job. You have put risk and good risk governance high up on the agenda for your organization. From the board down they are aware of the lessons and implications of the credit crisis, of increased regulator intervention and of many new rules. Everyone agrees that sound risk management and governance has to be embedded deep into the organisation's culture processes and procedures and you are the person for the job.

The Challenge

Congratulations and now you have a challenge: what does all this mean in practice for your organization?

For instance,

- How will you put in place controls around something you haven't defined?
- How will you record risks when you can't afford to upgrade the system?
- How will you get people to adopt what they don't understand?
- How will you explain it to the Board?
- How will you know when you have been successful?

You know that good risk or credit risk management does not happen in isolation of the business. Unfortunately in some organizations, the necessary establishment of risk as an independent function has meant that there is not always the recognition that management of risk occurs across all business activities and is not just the purview of the risk function.

The quality of business being written and the level of losses are not just the responsibility of the credit department. Conversely the credit risk function has a role to play in each stage of the business cycle from planning and product design through to collecting the profits not just in sanctioning transactions. Additionally, from the outset good risk management will not become embedded in the organization unless you bring people along with you and they will not be open to change (If change is needed) unless they have a compelling set of reasons to do so.

For example, the finer points of the Turner Review may not present such a compelling reason for change to your branch loan officers as it does to the Chairman of the Board. So early on it's a good idea to get a message across that everyone can start relating to.

A suggestion would be to communicate how good risk management will benefit everyone in the organization by enabling business sustainability and growth through:

- Efficient and effective decision making balancing risk and reward within the context of a well defined business strategy and risk appetite
- Containment of costs and losses as well as increased revenue from exploitation of new business opportunities
- Ensuring that business decisions are made and the business operates in line with a defined framework of values and principles and appropriate standards of risk management and governance are met.

You will have to put this into your own words, of course, as you will know what best suits your organization and culture. A hint: you really do have to connect with as many people as possible when you get it out there as they won't hear your message until they know you care, so think big. Having started to paint a picture of

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where you are headed in broad terms the next step is to work out where you are at present. A great way to do this apart from looking at what documentation, reports internal and external etc you have is to actually ask a good cross- section of your key stakeholders. This will also have the benefit of engaging a wide variety of people into what you are trying to achieve early on. It may include the board and the regulator but don't forget the more junior members of your team and the sales people and/or relationship managers and loan

officers who have direct contact with the customers. These people usually have a really good idea of what is going on your organization and it's just that so far maybe no one has thought to ask them. Try and think laterally about the type of data that will be helpful, e.g. if staff engagement data is available a low score will give you a fair indication that the risk culture will be wanting. The same goes for customer satisfaction surveys. Further, high turnover in credit risk roles could also indicate issues.

Getting Organised

To more easily pull it together at the end it is best to have some kind of checklist and structure to the questions and areas where you are going to take a closer look. The areas to be considered usually fall under four broad headings:

1. **Strategic**
2. **Structure and framework**
3. **Process and portfolio**
4. **People and capabilities**

The actual questions and their weight again will depend on your organisation's circumstances, including your regulatory environment. Be clear which elements are mandatory, i.e. prescribed by law and regulation or regulator endorsed reports such as the Walker review in the UK, which questions are more about best practice and which are internal and in line with strategy or the brand value (e.g. a customer charter). Be aware also that although there may not be rules on, say, the appropriateness of data, a regulator may have difficulty in seeing how a firm can have effective risk management as required under its rules without the appropriate data being available.

The answers to the questions will also help you identify potential problem areas early on so you can take action quickly. Also it is a good idea to keep the questions broadly focussed initially rather than limiting them to those you believe solely relevant to credit risk. Risk types and business processes are closely linked. You may discover for instance that in order to improve the credit quality of the book the collections process or the documentation process may need to be addressed and neither process may be the direct responsibility of the credit risk function.

1 Strategic

Mission and objectives

- Is there a mission statement for the business and objectives?
- Is there one for the credit risk function? Are they consistent?

Strategic Plan

- Does your organization have a fully integrated planning process from 1 to 3 years?
- Is credit risk an integral part of the process? Are losses planned for and if so how?
- Is there a clear set of priorities for the business and likewise credit risk and are both consistent?

Risk Appetite

- Is the amount and type of credit risk that the organization is willing to bear clearly articulated?
- Does the Board approve it?
- Is it well understood?
- Does it inform business decisions?
- Is there a balance between risk and reward at every level of decision making?
- Does it inform portfolio management?
- Does it align with business strategy and expected returns? Are there formalised risk triggers?

Capital management

- Whose job is it to manage?
- Who provides oversight?
- Do you have a Capital Management Committee?
- What data is it based on?
- What is the extent of your stress testing?
- How is capital apportioned?

2 Structure & Framework

Committees

- Is there a separate Risk Committee?
- Do you have a Credit Committee?
- Who sits on them?
- What are their powers?
- Who are they accountable to?
- What is in their charter?
- Who reports to them?
- Who measures committee effectiveness?
- In regards to the charter for a risk committee for example one would expect some or all of the following elements to be present:
  - Members all or mostly independent non executives
  - Minimum meetings per year
  - Overall authority to determine risk framework
  - Powers to delegate
  - Establishes risk appetite and recommends to the board
  - Recommends changes to the board on risk strategy and policy
  - Overviews risk control and assurance framework
  - Monitors risk exposure and profile against risk appetite
  - Monitors and reviews risk exposures, issues and risk reporting

Structure

- Is the risk function independent?
- Who does the CRO and CCO report to? the CFO? the Risk Committee? The CEO?
- Who determines the remuneration of the CRO and the CCO and the rest of the risk team? (For example, if the business controls this then one might have to question the ability of the function to be truly independent).
- Do you have an internal audit function?
- Who performs risk assurance?
- Is the credit risk function and process audited?

Policies

- Is there a full suite of policies covering all aspects of the credit risk framework (such as delegations, exposures, assessment criteria, loan to value criteria, collateral, write offs etc)?
- Who monitors and reports that these have been adhered to?

3 Process and Portfolio

Approvals & Process

- Is the credit approvals process well articulated are responsibilities and accountabilities well defined and aligned?
- Are approval authorities based on actual risk exposure?
- How is this measured and monitored?
- Is there a risk based approach?
- Are approval authorities attached to roles or the capabilities of the actual people in them?
- Is there a standard applications form? a standard credit submission form?
- What are the minimum criteria for approval?
- Who determines pricing?
- Does risk have a say in the return required for the risk being undertaken? In product design? In due diligence?
- Who monitors that loan covenants have been adhered to?
- Who approves and monitors overrides and exceptions?

Models

- What is the extent of credit model usage in your organization?
- Who builds and monitors their performance and are these functions separate?
- Does the business have any role in their oversight?
- What data do they use? Is it adequate?

Data

- Is the credit data sufficient to allow for estimation of default probability over a cycle?
- Is it detailed enough to allow for proper tracking of underlying drivers of risk in the credit portfolio?
- Can you aggregate all exposure types to each obligor, each industry type etc?
- What information gets reported to management and the board, who compiles it?
- Who analyses it/ who maintains it?
- Is it independently maintained, reconciled and audited?

Systems

- What exposure management and risk reporting systems do you have in place?
- Are they the same systems you use for financial reporting and if not can you reconcile between the two and who performs the reconciliation?
- Are your systems appropriate for the level of data you have available and for how your organization operates and requires information?
- If you rely on spreadsheets, which may be more appropriate to the size of your organization, who builds and maintains and monitors them?
- Who approves system and spreadsheet changes?

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4 People and Capabilities

Increasingly there is the expectation from regulators that it is the firm's responsibility to ensure that all persons in control functions and in significant influence functions are fit and proper for the role. Further changes are expected to tighten the Approved Persons – Significant Influence functions regime in the UK, for example, with many other jurisdictions likely to follow suit.

The implications for the required capabilities of individuals in the credit risk function and those overseeing business writing are obvious. Areas to be addressed in any assessment would include role clarity, understanding of credit principles and practice in risk and the business, accountability for the same, extent of ongoing training in credit Basel and regulatory requirements, analytical capabilities, understanding of credit principles, requirements etc in all oversight functions including board and business committees.

The regulators have also expressed a strong interest in remuneration policies particularly in regards to bonuses. However, at a less visible level it is apparent that there is a growing interest in remuneration in general and how risk management functions particularly in credit sanctioning are being treated. An imbalance between those with significant influence on the risk:return equation where it may lead to a greater incentive to write the business rather than to its quality is likely to draw critical attention.

Ready to get started?

The above questions are just an example to get you started. Do bear in mind that you probably do not have many weeks in order to pull a great deal of information together. You will just have to gather what you can in the time available and then like any good credit risk professional exercise judgement.

Let's summarise. At the start of your journey to embed good credit risk and governance and practice into your organization it is a good idea to have a general idea of where you would like to get to and then to take stock .

Once this is achieved you can begin to formulate a plan of what needs to be done and when and what resources will be needed.

The approach of looking at documentation and talking to as many stakeholders as you can have the advantage of helping to enjoin everyone to the cause. You will have an understanding of their needs and be able to get greater understanding and commitment from them as to what in your professional judgement needs to be done. True lasting change will not be sustained by forcing it on people; you will have to win hearts and minds by being open, inclusive and accepting feedback.

Don't forget

You may not get the perfect information. You will need to use judgement and make recommendations as to ideal conditions, timing and agreements. **The questions will be the framework of what is ideal.** You will be able to match that against the current situation. From this will emerge priorities for action. Keep everyone informed of the outcome and your recommendations. You will need their support and ownership.

In coming articles we will discuss some of the key areas above in more depth. Taking Risk Appetite, for example, we will look at the practicalities of quantifying it for your organization embedding it into decision making, reporting and explaining it to all your stakeholders so that it has relevance to them.