Corporate governance: What can we learn from the west?

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Discussion topics

Western governance failures and lessons learned

Risk Appetite

Risk Culture

The Global Financial Crisis evidenced catastrophic failures of risk management & governance…

- Failure and rescue of some of world's previously most prestigious institutions
- Severe damage to others
- Wholesale nationalisation of banks in many European countries
- Estimated $10 trn of bad assets
- Multi-trillion dollar rescue packages
- Bankcruptcy of Iceland
- Downgrading of Spain, Greece, Ireland – UK? US?
- Complete freezing of inter-bank lending markets
- Major recession worldwide

➢ *The "unthinkable" can happen!*

The "Senior Supervisors Group" provided the first official diagnosis of risk management failures in March 2008 and then published a deeper analysis of the risk management & governance failures in October 2009

SSG Background

The Senior Supervisors Group

- Formed in 2007 in response to market events
- Comprises 9 supervisory agencies from 7 countries
- Supports the priorities of the Financial Stability Board
- Is not a policy-setting body

SOURCE: Senior Supervisors Group

Principal conclusions from second (Oct. 2009) SSG report confirm & detail systemic governance failures in the 20 largest north Atlantic firms (I)

Overarching Observation (1/2)

- **Weaknesses in governance, incentives, and infrastructure undermined the effectiveness of risk controls and contributed to last year's systemic vulnerability**
  - The 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

SOURCE: Risk Management Lessons from the Global Banking Crisis of 2008, Senior Supervisors Group, 21 October 2009

Principal conclusions from second (Oct. 2009) SSG report confirm & detail systemic governance failures in the 20 largest north Atlantic firms (II)

Boards didn't understand the risks that were being taken by the management

Overarching Observation (2/2)

- **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
- **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

SOURCE: Risk Management Lessons from the Global Banking Crisis of 2008, Senior Supervisors Group, 21 October 2009

SSG (Oct. 2009): Lots of critical improvement still needed, much work to do – needed improvements will take several years

Critical Areas of Needed Improvement

- **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

SOURCE: Risk Management Lessons from the Global Banking Crisis of 2008, Senior Supervisors Group, 21 October 2009

How can we explain these systemic failures of risk governance in the GFC? Consider 3 key, high-level challenges for effective risk management

- *Key challenges for risk management effectiveness include:*
  - ***Seeing*** how the external environment is changing & perceiving the drivers of these changes (e.g., US house price declines, diminishing market liquidity)
  - ***Understanding*** the current and potential impacts of these changes across all businesses, portfolios and geographies – ("joining the dots" & looking forward)
  - ***Acting*** quickly to reduce risk when necessary (disappoint the market if necessary!)

- All 3 of these tasks are challenging in practice!

- In particular, for banks with non-traditional business models the aggregate, integrated risk profile of the firm & the way this is changing is fundamentally opaque, to insiders as well as to outsiders, and very challenging for senior management and directors to properly understand
  - the GFC evidenced many examples of ***cognitive failure at the Board level***

- *Conclude:* **the risk governance challenges for Boards are complex and formidable, especially for large institutions with complex business models**

- *Note: Backward-looking statistical tables and reports have only limited utility for understanding the way aggregate, integrated risks are growing and changing*

- ***Importantly for Asia*** - for simpler bank business models, the problem is not so acute – risks are more traditional, and (in general) easier to see and understand…

The IIF Committee on Market Best Practices recommended 6 areas for industry action in its July 2008 final report; IIF Steering Committee on Implementation reported on industry progress December 2009

- The global industry response to the credit and liquidity crisis was formulated through the Committee on Market Best Practices (CMBP) of the Washington-based Institute of International Finance (IIF)
- The Committee (consisting of representatives from over 65 IIF member institutions, including rating agencies and investors) engaged 6 Working Groups to address key areas of focus
- Its July 2008 report contains Principles of Conduct and >150 specific recommendations in 6 main areas for industry action

Areas for industry action

1. Risk Management
2. Compensation Policies
3. Liquidity Risk, Conduits and Securitization
4. Valuation
5. Credit Underwriting, Ratings and Investor Due Diligence in Securitization Markets
6. Transparency and Disclosure

SOURCE: Final Report of IIF Committee on Market Best Practices, July 2008 www.iif.com

Risk Management – Key IIF Recommendations Summary (July 2008)

8 Principles of Conduct & 58 Specific Best-Practice Recommendations

Risk culture and accountability	▪ Firms should develop a robust risk culture - incorporated in the way the firm operates - covering all areas and activities ▪ Accountability for risk management should be a priority for the whole institution
Role of the Board	▪ Senior management, particularly the CEO, is responsible for risk management ▪ Board has an essential oversight role ▪ Boards should consider having a dedicated Risk Management subcommittee
Comprehensive perspective	▪ Define and articulate risk appetite and ensure its adoption throughout the firm ▪ Ensure consistency between risk appetite and strategy ▪ Take integrated approach to capturing all sources of risk (incl. off-B/S exposures) ▪ Take into account technical limitations of risk models such as Value at Risk (VaR)
Role of the Chief Risk Officer (CRO)	▪ Assign responsibility for all risks across the firm to a single senior individual ▪ Ensure that the CRO can influence key decision-makers within the firm ▪ CRO mandate to ascertain that the firm's overall risk level is consistent with its risk appetite & to provide a thoughtful, integrated view of overall risks ▪ Support senior management by identifying emerging risks & concentrations

SOURCE: Final Report of IIF Committee on Market Best Practices, July 2008 www.iif.com

Compensation – Key IIF Recommendations Summary (July 2008)

Shareholders' interests	Incentives should be aligned with long-term, firm-wide profitability
Risk-adjusted compensation	Incentives should not induce risk-taking in excess of the firm's risk appetite; firms should base compensation on risk-adjusted performance
Severance pay	This should take into account realized performance for shareholders over time, and consider the circumstances of severance
Transparency	The industry must show leadership in developing a better, more transparent approach to compensation practices

Summary IIF July 2008 recommendations for effective Risk Governance

Structure

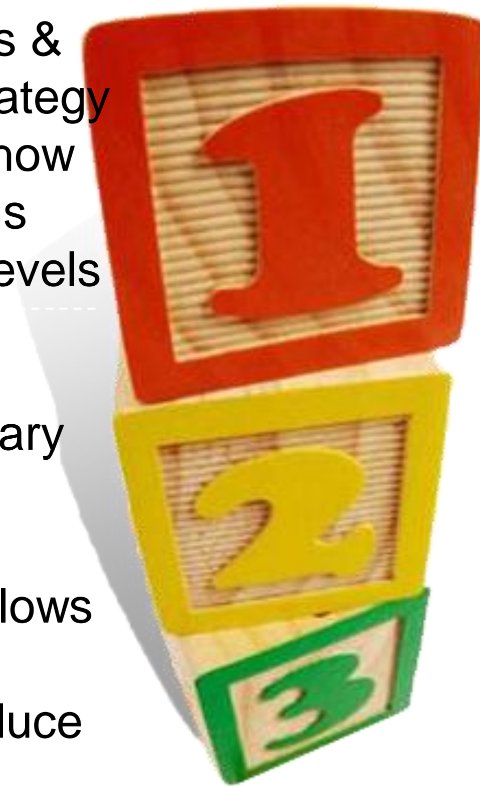
- Dedicated Board Risk Management Committee, with strong banking experience & risk management skills
- Independent Chief Risk Officer responsible for all risks, reporting to CEO and Board, with stature to influence decisions
- Adequately resourced risk management organization

Board Responsibility

- Clearly define risk appetite for all businesses & ensure coherence with business plans & strategy
- Deeply understand integrated risk profile & how this is changing, including risk concentrations
- Ensure effective dialogue about risks at all levels

Culture

- Ensure risk culture is robust and effective – diagnose & address weaknesses as necessary
  - Ensure all employees understand their responsibilities for risk management
  - Ensure (formal and informal) information flows are effective and "bad news travels"
  - Ensure compensation schemes do not induce risk-taking in excess of firm's risk appetite



SOURCE: Final Report of IIF Committee on Market Best Practices, July 2008 www.iif.com

IIF view on progress: substantial further strengthening required (Dec 2009)

Key findings of the IIF Steering Committee on Implementation (SCI) report

- Financial institutions have invested considerable resources in necessary improvements; significant changes are underway
- Strengthening risk management is currently a top priority - risk functions being reconfigured and upgraded for a more integrated approach to risk management. Specific areas of improvement include:
  - Governance and transparency;
  - Stress testing;
  - Liquidity risk management;
  - Risk measurement; and
  - Risk-aligned compensation policies
- Institutional culture is changing - perceptible shift in orientation from “sales-driven” to more “risk-focused.”
- Firms are formalizing valuation reporting frameworks, with increased involvement of senior management — including the CFO and CRO functions— in valuation and reporting processes
- <u>*Key Impediments to Change:*</u>
  - Degree of cultural change required in firms;
  - Dependency on few senior personnel; and
  - IT/technology changes and dealing with legacy systems that are harder to change
- Essential to build systems and incentives which are sufficiently robust to ensure that changes made are real and enduring
- Greater IT investment required in risk management and risk-monitoring systems
- Reforms need to be institutionalized through governance changes

SOURCE: “Reforms in the Financial Services Industry: Strengthening Practices for a More Stable System” (Steering Committee on Implementation Report), December 2009 www.iif.com

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Risk Appetite

Risk Culture

Clarifying and embedding Risk Appetite is a complex and important CEO and Board responsibility, which has evolved considerably in recent times

Prior to the Financial Crisis, "risk appetite" was typically a very vague notion, often characterised by very general statements, e.g.:

- "Low risk"
- Target credit rating…
- Target for earnings volatility
  - These objectives were typically informed by a high-level perspective of the firm's intended risk profile vs peers (lower/similar/slightly higher – hopefully offset by greater returns from higher-risk businesses?)…
  - In practice, it was implicitly expected and understood that individual BUs would selectively "dial up" their actual risk taking within individual reporting periods if needed to meet revenue targets, within certain (implicit?) boundaries

- However, during the bubble which preceded the financial crisis, in pursuit of incremental revenue individual businesses within many firms took substantial risks that they did not understand, and which they were not explicitly authorised to take…
- The resulting catastrophic losses underscored that the aggregate, integrated risk profile of the firm & the way this is changing is fundamentally opaque, to insiders as well as to outsiders, and very challenging for firms, shareholders and supervisors to properly understand
  - Post-crisis, it has now become essential to clarify in advance exactly which risks are acceptable, and how much of each can be taken, in each business and in aggregate across the firm.

- This is a very challenging and complex task, requiring active business involvement and directly linking to target setting and performance planning…

Indicative questions for CEO and Board to consider when defining risk appetite (I)

– *Business model/competitive advantage:*

- What is our overall growth strategy? *Examples:*
  - core businesses & markets, preference for organic vs inorganic growth vs JVs etc.; target credit rating
- Which risks are core to our overall strategy?
- Which risks do we understand and manage well? Which risks can we avoid or transfer?
- Which risks do we have a competitive advantage in assuming? Which risks are we paid excess returns for assuming?
- Which risks will we seek to minimize and control, which cannot be avoided completely? (*Examples*: regulatory, legal, operational, compliance, reputational risks etc.)
- Which risks do we not understand well enough – where do we need to build capability and understanding – either because these risks are core to our business strategy, or because we may be unacceptably exposed?

SOURCE: Mark Lawrence Group – see: "Reforms in the Financial Services Industry: Strengthening Practices for a More Stable System" (Steering Committee on Implementation Report), December 2009 www.iif.com

Indicative questions for CEO and Board to consider when defining risk appetite (II)

– *Risk tolerance, capital and limits:*

- For each risk, how much of this risk can we successfully take and manage? (Risk capacity)
- For each risk, how much of this risk do we choose to take and manage? (Risk appetite)
- *Specifically:* what is our tolerance for aggregate total losses over 1 year, with varying probabilities:
  - ➢ Across the entire group (*Examples:* “We can accept a 1 in 10 chance of losing $X in a year, a 1 in 20 chance of losing $Y, and a 1% chance of losing $Z”)?
  - ➢ In each geographic location or business line? For a single transaction?
- Does this tolerance vary depending upon the location of the losses (eg home markets vs offshore)?
- Are these risk tolerances consistent with our performance (profit, RoE) and growth targets, and our capital, funding and liquidity position? What are the implications of actually sustaining losses of this size – what would we do?
- What is the minimum level of capital that we must preserve after sustaining large losses, after taking into account our earnings capacity? What fraction does this represent of our current total capital and tier 1 common equity? What does this imply about our aggregate total loss tolerance?
- What kind of limit frameworks are needed to make these various risk tolerances clear to employees internally?
- Are the current limits consistent with these tolerances for loss?

SOURCE: Mark Lawrence Group – see: “Reforms in the Financial Services Industry: Strengthening Practices for a More Stable System” (Steering Committee on Implementation Report), December 2009 www.iif.com

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Establishing a robust "risk culture" is of paramount importance in ensuring effective risk management – a CEO & Board responsibility

- Many believe **culture** is the **most important determinant** of risk management effectiveness – consistent with industry consensus

- Important to understand the **impossibility of knowing everything that you need to know** about emerging risks & rapid changes to the risk profile of the firm through formal channels (committees, risk reports etc …)

- Therefore, ***effective "informal" channels*** for information ***are essential***

- In particular, to balance risk & return at every level, firms should:
  - Deliberately **create an 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 and CEO – the ***CEO must lead by example, continually emphasising the importance of properly understanding risks*** and seeking to objectively balance risk & return …

- ***Key question for the CEO and Board:*** What exactly do we mean by "risk culture"?
  - How can the CEO, Board and Directors objectively assess and understand the strengths and weaknesses of the firm's risk culture?
  - … and what specific actions can be taken to strengthen the risk culture?

What exactly is "risk culture"? There is currently no consensus definition

IIF definition (December 2009)

Risk culture can be defined as…

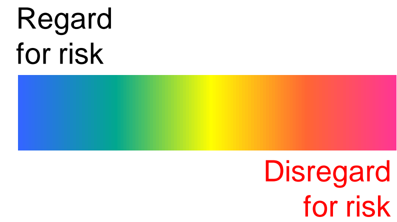
"The norms and traditions of behaviour of individuals and of groups within an organization that determine the way in which they identify, understand, discuss and act upon the risks the organization confronts and the risks it takes."

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

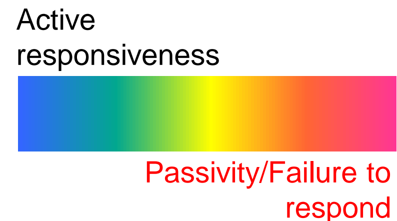
The things that go wrong, do so predictably… risk culture can be diagnosed and shaped over time

Risk culture category spectrums

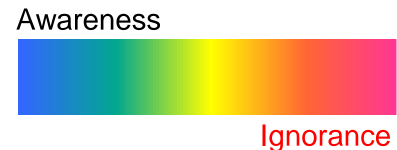


Causes/symptoms of risk culture failure	Definitions
1 Overconfidence	• Belief that an organisation/ individual has a competitive advantage (thanks to self-perceived superiority); or groups/individuals are immune/insulated from risk
2 "Beat the system" (for personal advancement)	• Internal and/or external agents can conceive and operationalise a fraud; or agent risk appetite is misaligned with the organisation's
3 BU Gaming (for unit's advancement)	• Individual units take risks which are not in line with organisational risk appetite

Causes/symptoms of risk culture failure	Definitions
4 No challenge	• A culture where individuals do not challenge each others' attitudes, ideas and actions; possibly as a result of overly positive visionary leader
5 Fear of bad news (for own mistakes/external news)	• A culture where management and employees feel inhibited about passing on bad news



Causes/symptoms of risk culture failure	Definitions
6 Failure to share signals	• Warning signs of both internal or external risks are not shared
7 Indifference/sloppiness	• A reluctance to react to situations; to not care about the outcome either due to bad faith or incompetence
8 Slow to respond to change	• Organisation perceives external changes but reacts too late; is in denial about innovation or fear of change



Causes/symptoms of risk culture failure	Definitions
9 Unclear risk tolerance	• A firm where the leadership has not communicated a clear risk appetite for the firm to the levels below or has presented a single dimensional approach
10 Lack of true risk insight	• The organization fails to understand the true nature of the risks it is running or thinks that it is the preserve of risk specialists

Source: McKinsey analysis

Conclusion – substantial risk and strategic agenda ahead for Asian banks

Risk management and governance:
must strengthen at all levels

- Strengthen risk governance and build risk management capabilities to prepare for more complex business models and future reduced dependence on highly prescriptive regulation for risk management
- More tightly and comprehensively define and embed risk appetite over time, looking through the complete economic cycle
- Review performance & robustness of risk models + strengthen stress testing capabilities
- Improve risk transparency – strengthen risk IT systems & databases
- Strengthen "risk culture", as tailored to local circumstances

Strategy:
assess strategic implications of forthcoming prudential regulations & link to risk appetite

- Assess RoE and pricing implications of new (and already announced) Basel III capital charges, leverage ratios & liquidity requirements for business lines and products
- Understand the economic and competitive implications of these changes for business models & portfolio mix
- Closely link risk appetite and strategy as business models evolve and risk profiles become more complex & opaque
- Actively engage with regulators re: timing and implementation of new regulations

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