

# The Future Role of Risk Governance in Banks

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# 1. Developmental Trends in the Finance Industry – Result: increasing volatility

## 1.1 Products

- Complex, diverse OTC-derivatives, certificates, ABS, LBO
- Transparent risk-oriented pricing
- Regulated credit trading based on external ratings

## 1.2 Technology

- Immense memory and processing power
- Outsourcing networks
- Program diversity

## 1.3 Real Economy

- Environment
- Energy
- New materials
- Dynamic global trade with financial imbalances

## 1.4 Customers

- Reduced customer loyalty
- Insufficient financial knowledge within households
- Credit squeeze in SMEs
- Ratings / Orientation towards capital markets

## 1.5 Competition

- Near- and non-banks advancing (private equity, hedge funds)
- Foreign banks
- Becoming remarkable competitors

## 1.6 Shareholders

- Hedge funds
- Rebellious shareholders
- More transparency
- Increasing power of analysts and institutional investors

## 1.7 Regulation

- Financial crisis
- G20 and FSB
- Basel Committee, EU (CEBS), National supervisors (BaFin)
- Basel II + III

## 1.8 Management / Employees

- Uncertainty
- Liability issues
- Loss of loyalty
- Investment banking behaviour

## 1.9 Corporate Governance

- Liability issues
- Codes of conduct
- Female quota

## 1.10 Communication

- Transparency guidelines
- Ad hoc rules requested by analysts
- Increasing power of Rating Agencies

## 1.11 Accounting

- Complex, heterogeneous
- Fair value, mark to model and index
- IFRS-Board with steady accounting reforms

## 1.12 Values / Incentives

- Bonus / penalty
- Bankers as underdogs
- New remuneration models
- Loss of integrity and esprit de corps

## 2. Success Factors: Forward-looking View and Risk Orientation

**2.1** The banking landscape is constantly subject to dynamic developments and erratic structural changes, altering the basis for successful bank management and causing great uncertainty

⇒ High volatility means that risk strategy and risk management are key success factors

**2.3** Risk management is the second key factor, i.e., risk assessment within the market along with early recognition, risk strategy, predictability of the market and portfolio quality (stress and scenario analyses)

⇒ Tracking negative developments and the ability to counteract on them

**2.2** The business model is the first key factor for success, i.e., strategic focus towards customers, products, regions, sales channels, technology, competitor positioning, efficiency as well as implementation strategies and the ability to react to changed market conditions

⇒ Business model needs to be profitable through the cycle

**2.4** Since there are various solutions (but "march of the lemmings"?), there will undoubtedly be different approaches to the implementation of the success factors and, thus, winners and losers. The readiness and abilities of politicians and regulators to "punish" and exclude the losers will increase

⇒ To counteract on volatility, implementing counter-cyclical measures in risk governance is a key instrument

# 3. Elements of Oversight and Banking Supervision

## 3.1 General legal framework / Liability / Judiciary

- German Companies Act (AktG), Banking Act (KWG), Criminal Code (StGB): "soft law" will become increasingly important (EU standards, Minimum Requirements for Risk Management, Corp. Gov. Codes of Conduct; e.g. CEBS-Paper from Feb. 2010)
- Increased liability for management

## 3.2 Shareholder/ Analysts / Rating Agencies

- Increased levels of information / short-term orientation communicated via annual and quarterly reports, and analyst reports
- Positive assessment of the information is vital to capital markets transactions as well as refinancing

## 3.3 Politics / Public Opinion / Press

- Increased sensitivity in the wake of the financial crisis, which has resulted in the need for increased levels of public information
- Bank managers left with tarnished image and declined influence, misconduct is stigmatised

## 3.4 Accountants

- Increasingly acting as extended arm of the audit committee as well as the regulator
- Backward-looking, rules-based

## 3.5 Regulation / Supervision

- Bureaucratic, classified
- Lack of qualification, poorly paid
- G20 / FSB / Basel Committee setting the pace, current trend towards high performance regulation

## 3.6 Corporate Governance

- Codes of conduct not bank-specific
- Supervisory board has not been the focus of bank regulation
- Risk governance is insufficient
- Momentum from "Walker Report"
- "Principles for Enhancing Corporate Governance" from the Basel Committee

# 4. Risk Governance Goals

## 4.1 Create Transparency with regards to the bank's financial condition and the way it monitors risk

- Systematic overview of all types of risk and portfolios as part of a comprehensive system
- Are information and reporting procedures within the bank suitable to quickly highlight potential risk?

## 4.2 Effective managerial involvement in risk assessment and risk management

- Dynamic risk management achieved via qualification, communication, collaboration of market-related board members, CRO, CFO and CEO

## 4.3 Effective risk management monitoring system

- Assessment of effectiveness / functionality of risk management organisation
- This includes, e.g. consistent methods and processes as well as the observation of the aforementioned
- Furthermore, it requires responsible credit decision-making powers, a powerful work-out organisation, timely and adequate provision of information regarding impact on income, sufficient resources, and more efficient use of available resources

## 4.4 Monitoring the risk culture's effectiveness

- Capable employees with strong personal values
- Risk management, including: independent credit decisions detached from "his master's voice"
- Culture of opposing views, time-to-market orientation, ability to deal with conflict, integrity, commercial prudence principle, open communication, etc.

# 5. Risk Governance Topics

## 5.1 Report on overall risk situation

- Risk cockpit with warning and danger signals defined for all risk parameters for credit, market and operational risks

## 5.2 Risk taking capacity / risk appetite

- Regulatory and economic capital view
- ICAAP rule of §25a KWG

## 5.3 Risk strategy

- Market / portfolio analysis
- Operationalisation
- Supervision
- Stress and scenario analyses
- Countermeasures and counter-cyclical steering concept

## 5.4 Impact on earnings

- Risk provisions (general and specific) / impairments
- Accounting losses
- Operational risk / legal risk
- Planning and monitoring volatility

## 5.5 Concentration risks

- Individual cases
- Credit, market and income risks to portfolios
- Correlations
- Rating migrations

## 5.6 Prevention and intensive treatment (work-out)

- 20 biggest-list
- Coverage ratios
- Post-mortem analyses
- Inflow-outflow

## 5.7 Unquantifiable risks

- Reputational risk
- Insider trading
- Money laundering
- General compliance
- Staff risks

## 5.8 Further developments for risk management

- Regulatory compliance
- Projects
- System weaknesses
- Employee qualification

## 5.9 Detailed analysis

- Portfolio batches
- Individual cases (e.g. „Organkredite“)
- Due diligence results, e.g., as part of M&A transactions
- Screening and detailed analysis of individual risk types

# 6. Risk Committee (RC): the Central Institution

## 6.1 Responsibilities

- Collaboration / division of responsibilities between the Supervisory Board (SB) and its committees

## 6.2 Committee matters

- Analysis vs. consultancy vs. recommendations vs. approval
- Valuation and information to SB and Board

## 6.3 Agenda

- Targets / goals
- Focus
- Qualification of members
- Meetings
- (ad hoc) Reporting obligations
- Support function

## 6.4 Role of / Demands on Risk Committee (RC) Chair

- No double function with the SB-Chair
- Good cooperation with the CRO

## 6.5 Demands on RC members

- Financial expert (§107 AktG)
- Need to understand the risk profile of the bank

## 6.6 Collaboration with Executive Board

- RC must understand the cooperation
  - Within the board
  - The role of CRO, CEO, CFO and board members with market responsibility

## 6.7 Collaboration with other bank employees and third parties

- Risk
- Compliance
- Internal and external Auditors
- BaFin
- Analysts
- Rating Agencies

## 6.8 Meeting schedule

- Frequency
- Duration
- Communication between meetings (ad hoc)
- Link to SB meetings

## 6.9 Meeting documentation

- Risk reports
- Agreed to dos
- Minutes
- Transparency requirements for presentations

# 7. Liability Issues for RC Members

## 7.1 Requirements for Business Judgement Rule (BJR)

- Corporate decisions for the company's benefit
- Without excessive risk
- On the basis of appropriate information
- Free from conflicts of interest

## 7.2 Knowledge required

- Ignorance is not a valid defence
- "TÜV" accreditation for accountants and regulators does not limit liability
- Insufficient knowledge and qualifications increase chances of negligence claims

## 7.3 Rights / duties

- Duty of supervision should be discharged retroactively, simultaneously and proactively (for business requiring approval)
- Key aspects of the business and its risks must be understood; executive board must declare this
- Obligation of confidentiality and loyalty

## 7.4 Civil liability

- Equally, this applies to the supervisory boards in cases where the BJR is breached
- "Sovereign knowledge" should be included in the meetings
- Slight negligence may suffice (reversal of the burden of proof)
- Judgemental assessment requires recommendation/ decision

## 7.5 Criminal liability

- Germany: Breach of trust according to §266 StGB: up to five years of imprisonment, limitation statutes will be increased to ten years
- Conditional intent is sufficient (possible damages are not related to expected benefits)

## 7.6 Current developments

- Critical decisions should be taken / prepared in the RC
- Reason for particular focus: liability of RC members conceivably reduced as a result of case law
- Various current lawsuits are creating uncertainty

# 8. RC's Weakness – Risk Assessment

## 8.1

- Non-functional early warning system for risks and/or
  - Insufficient recognition of the indicators
- Board needs to deliver and SB/RC must understand, evaluate and demand

## 8.2

- Risks are (intentionally) portrayed incorrectly or trivialised by the board of managing directors
- Failures of the board need to be understood by the SB/RC

## 8.3

- Insufficient understanding of complex systems and/or cause-effect relationships
  - Weaknesses could be caused by the board and/or the SB/RC
- Train (qualification) or exchange!

## 8.4

- Too great a dependency on formal models
  - Often forgotten that these are only an approximation of reality
- RC should ask for expert knowledge if necessary – via the risk function or external experts

## 8.5

- Stakeholders and customers are not appropriately involved in early warning risk processes
- Try to listen to members of client-groups

## 8.6

- Cognitive barriers exist, which means that events outside of people's experience are not assessed ("black swans")
- Try to understand systemic and macroeconomic risks

# 9. RC's Weakness – Management Evaluation

## 9.1

- No alternative risk management strategies / options have been thought through and evaluated
- RC should ask for stress and scenario analysis and business judgement / opinions

## 9.2

- The time-span between risk emergence, recognition and management as well as the introduction of countermeasures and them taking effect is insufficient
- RC should highlight the need for counter-cyclical steering concepts

## 9.3

- Insufficient knowledge of the risk management tool box, meaning that suitable tools are not used
- Discuss alternative measures and listen to external experts

## 9.4

- Insufficient reaction to early risk recognition
- Often, people rely too much on hope and prayers when deciding whether "to take action or not"
- RC should ask for measures with timelines and learn about board behaviours through „post mortem“ analysis

## 9.5

- Common dialogue is not used to resolve management conflicts resulting from varied interests, values, states of knowledge, backgrounds, dependencies
- RC must carefully listen, understand, remind and if necessary ask for personal measures

## 9.6

- The right decisions are made
- However, the organisation is not in the position to implement them, e.g. due to a lack of resources, reluctance, lack of project management skills or lack of cooperation
- Weaknesses in implementation must be diagnosed by the RC

# 10. RC' Work – The Difference Between Reality and „Best Practice“

## 10.1

The four risk management targets have not been sufficiently observed and/or insufficient tools have been used

## 10.2

Risk governance topics / agenda are not processed systematically due to a lack of guidance, time pressures, poor preparation, or lack of skills, etc.

## 10.3

The risk committee is poorly chaired or is poorly assembled. Therefore, it cannot effectively engage with the executive board, other bank employees, or third parties, who are necessary to maintain required transparency concerning financial condition and risk management efforts with in the bank

## 10.4

The risk committee fails to reach an appropriate decision and/or assessment when evaluating and assessing the bank's risk situation and the executive board's risk management performance

## 10.5

The risk committee does not sufficiently follow the requirements of the BJR when making decisions/assessments and/or there is a lack of clarity, care and consistency when making critical, existential decisions

## 10.6

The risk committee is not in a position or does not wish to share its assessment of the risk situation and the executive board's risk management performance with the entire supervisory board. This means the supervisory board cannot fulfil its supervisory duties

# 11. Measures for Improving the Professionalism of Risk Governance

## 11.1

Reasonable and professional mix between RC chair and RC members in terms of technical abilities, character, independence, division between RC and supervisory board chairs; cooling-off period

## 11.2

RC chair appointment should be tied to regulatory approval: BaFin should establish clear requirements for suitability (skills and character) in relation to bank's size and complexity

## 11.3

Clear guidelines for the regulator's work and closer cooperation between the RC and regulator. BaFin should integrate the SB/RC in Regulatory Controlling (change to KWG)

## 11.4

CRO board member must report directly to the RC, act on its advice and is strengthened by its independence (the CRO should only be dismissed with RC's approval)

## 11.5

Obligatory training and qualification for RC members using certified programmes. Minimum requirements for RC members established by the regulator

## 11.6

Consistent warnings, removal, punishment for misconduct and violations of the BJR by RC members on the part of the regulator or justice system

# 12. Summary of „Good Risk Governance“ for Banks

## 12.1

Given the ever changing banking landscape, risk management has become more important than ever, often being the key factor in a bank's overall success or failure: forward-looking view, stress and scenario analyses, operationalized risk strategies, early recognition and consistent countermeasures are essential

## 12.2

Effective corporate governance of risk management promotes competitive driven decision making and aids in the development of broad guidelines rather than narrow, bureaucratic, and highly complex policies dictated by an external regulator

## 12.3

A bank's risk governance must fulfil four aims: creation of risk transparency, supervision of professional management, successful and effective risk management systems, as well as an effective risk culture

## 12.4

The risk committee must take sufficient time to deal with all risk issues: risk taking capability/-appetite, impact on income, risk strategy, concentration risks, etc.

## 12.5

As the central organ of the supervisory board for monitoring risk, high standards (qualification) concerning RC staffing need to be in place. In particular, this applies to the chair position. Rights and duties must be exercised and management misconduct must be countered acted consistently

## 12.6

Existing weaknesses should be systematically addressed and overcome in all areas (staffing, self-awareness, risk supervision, evaluation of the board's risk management performance); "best practice" must translate into standards. Regulator should create guidelines and approve the appointment of RC chair

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