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Risk Management, Governance & Controls – Importance for Overall System Stability: Perspective of a Regional Bank Advisor

Outline

- Hierarchy of Governance, Risk Management and Control
- System Wide Governance; Scope & Reality
- Firm Wide Risk Management
- Controls; Optimization and Effectiveness
- Conclusions & Recommendations

Hierarchy of Governance , Risk Management & Controls

- In the absence of adequate and effective Governance, Risk Management & Controls are a wasted investment
- Maintaining Systemic Stability warrants assessment of system wide Governance, and Risk Management
- This means Governance and Risk management at the level of the regulator, all FI's, and other players (e.g. rating agencies)
- Within FI's, Governance and Risk Management levels begin at the Board, but must also be assessed at various management and subsidiary levels

Hierarchy of Governance , Risk Management & Controls

- In a free market economy, systemic stability must, by definition, be a collaborative effort between the public and private sectors (interests)
- Governance and risk management in the private sector is unlikely to be effective, if not so at the public sector level
- This entails consideration of resourcing and empowerment of the regulator, as well as interaction, at multiple levels, with market players
- This also entails assessing the degree of influence over FI board members and governance structures

System Wide Governance; Scope & Reality

- While a significant amount of effort and documentation existed pre and post crisis to implement effective governance, questions remain over enforcement
- This arises, in my view, from resourcing and legacy practices
- The resource deficits apply equally to most regulators, FI Boards, and managements
- The issue is not only one of quantity, but more importantly of quality and qualification
- This factor overlaps with, and even influences, that of legacy practices

System Wide Governance; Scope & Reality

- Such factors have had an impact on enforcement of, inter alia, "Fit and Proper" requirements viz members of FI Boards and Board committees, including Risk and Audit committees
- They have also had an impact on the degree of empowerment of Risk directors and executives at FI firms
- This manifests itself in an imbalance between the shorter term shareholder value vs. public interest imperatives at FI firms, with the former gaining influence over the latter
- Misaligned incentive structures, risk appetites, metrics and practices are merely a manifestation of this imbalance

Firm Wide Risk Management

- Along with Governance, the crisis has made clear the impact of silo risk management , or deficiencies in Enterprise Wide Risk Management (ERM) implementation and practice
- The fact of the matter is that Bank processes and products do not carry independent risk types or strands
- An operational risk such as due diligence deficiency can “and did” lead to credit, market, reputational, and liquidity risks
- The same can be said of misaligned incentive structures
- A phenomenal operational failure was, yet again, the non recognition of an asset bubble in the making, in spite of manifest warning signals, i.e. overvalued real estate markets

Firm Wide Risk Management

- As worrying, if not more so, is that warnings when they occurred, were dismissed, and systemic, as well as firm wide concentrations overlooked
- Similar reactions occur when the tens of trillions of dollars worth of derivatives outstanding are pointed out, which include credit derivatives, as well as other OTC and esoteric derivatives, which at times, bare a resemblance to structured vehicles and products
- Areas that warrant further review and research include correlations between risk types, in these instruments, as well as other instruments and processes at FI firms

Controls; Optimization and Effectiveness

- As with Governance and Risk Management, one may view controls as being hierarchical in the financial system
- With the onset of Basel II, a macro control, in the capital adequacy framework has been the use of external ratings, and ratings agencies, especially under the Standardized Approach
- As was witnessed during the crisis, the degree of independence of ratings agencies has been placed into question, and hence their effectiveness
- As implied earlier, controls are only as effective as the context within which they are employed, be it the risk management context or the governance context

Controls; Optimization and Effectiveness

- Post crisis and post Basel II implementation, the number of controls prescribed has multiplied manifold
- Going beyond an optimum level of controls can actually be counter-productive, especially if they are employed within an ineffective risk or governance setting, be it on the micro or macro scale
- Raising too many red flags can lead to control fatigue, and insensitivity to major vulnerabilities, if or, when they are flagged within the deluge of warnings
- An optimization process must be employed, where a balance is struck between number, relevance, and effectiveness

Conclusions and Recommendations

- Quality and quantity of resourcing at multiple levels; Regulator, FI Boards and Management levels is a pre-requisite to addressing governance and risk issues
- Empowerment of Risk Champions across the hierarchy, i.e. at Board and Management levels, whilst requiring escalation
- Strongly recommend appointing at least two independent expert directors on Gulf FI Boards, Risk, and Audit Committees
- Recommend that Board or Committee decisions declined by both independent directors be shared with regulator for info
- Upgrading ERM frameworks at FI firms, to incorporate risk strand correlation, including operational and liquidity risks

Conclusions and Recommendations

- Strongly recommend establishment of well regulated regional external ratings agencies of high (int'l) standard
- Strongly recommend establishment of regional risk management forum or association, as a knowledge, skill, research and data repository for all Gulf FI's to access
- Realignment of compensation structures at FI Boards, as well as Managements, to be based on medium term "risk adjusted" performance metrics, which are independently reviewed
- Require training, certification, & annual appraisal of FI Board members, that covers governance, risk appetite, regulatory compliance, liquidity management, and stress testing

Conclusions and Recommendations

- Introduce compensation schemes at regulators that ensure attraction of the appropriate number and caliber of officers at multiple levels
- Employ system wide early warning systems, at regulators, that identify, inter alia, asset bubbles and system wide concentrations and/or vulnerabilities, along with major HR resource upgrade (this would entail remuneration enhancement at some GCC regulators)
- Establish regional cross border regulatory coordination, and financial sector review organization, such as a regional financial stability board

Conclusions and Recommendations

Thank You