GLOBAL riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

AUGUST 2012

10 Years and Growing

Libor
the risk lesson

Also in this issue

- What Makes a Chief Risk Officer Great?
- Making Enterprise Risk Management a Reality
- The Spanish Banking Sector – Where to Now?
- Islamic Finance – An Introduction
- Bank Internal Audit – New Standards from the BIS

What Makes a Chief Risk Officer Great?

The financial press reports the names and career status of Chief Risk Officers on a regular basis these days as claims of scandal, insider trading, mis-selling and rate fixing abound. Global Risk Update Editor in-Chief Dennis Cox opts to offer a normative view of the role of the Chief Risk Officer and considers the pitfalls, limitations and what it really takes to make a great CRO.

Banking industry has been implementing risk based rules for many years yet we still seem to get banks having difficulties. Why then is this the case? Are Chief Risk Officers (CRO) at fault and how should you find the right CRO for your firm? In this article we will explore the role of the CRO and the barriers faced in practice, suggesting appropriate approaches and solutions.

The Role of the CRO

The Risk Department within a bank is the unit that facilitates the bank taking risk. It does not take risks itself nor is it responsible for risk being incurred. This is the responsibility of the Board of Directors as delegated to its business units. The Risk Department under the management of the CRO is entrusted with developing an environment consistent with prudent risk taking. They create the structure whereby the systems of procedures and controls implemented at business unit level ensure the necessary level of control is maintained.

To achieve this, the Risk Department needs to have a detailed understanding of the nature of the activities of the firm and have approved the necessary policies and procedures needed to ensure that this is achieved. Of course policies and procedures alone are not sufficient. They need to be combined with robust monitoring and reporting. All of this is well understood – yet continued problems do appear to occur. Is it the failure of the CRO, the Board or the Risk Management concepts themselves?

The CRO is the person who should provide the ultimate risk vision. They should ensure that the management have the necessary tools available to them consistent with prudent risk taking. In the current regulatory environment the market's expectations are such that the level of direct involvement of risk within the business will be sure to have increased. Accordingly a more active involvement of the Risk Department and the CRO is required. But a CRO is only human and cannot be everywhere.

The CRO is reliant on the business implementing the systems and controls that are required and being honest in their reporting to the Risk Department, ensuring that adequate support is provided. If that information is incomplete or information is deliberately withheld then the CRO will not be in a position to provide their senior management with the information or direction that they require. Few CROs have been trained in all areas of risk management. In the case of commercial banks the majority of CROs have corporate credit risk as their key skill. In investment banks the route to the CRO is often through the market risk route. This can lead to a CRO having what might be best considered as being "hidden shallows" – that is that they have detailed experience of one area of risk management but are weak in another area.

This causes an obvious dilemma. Human nature means that the CRO will tend to focus their activity on the area of the business where their personal key skills are of greatest importance. They will essentially delegate their responsibilities in other areas to those who are experts in those fields – relying on their expertise. However, this leads to an obvious problem. In failing to have the ability to truly understand the additional risks that face the business the CRO is unable to appreciate the impact of one risk on another. Risk mitigation approaches that are effective in one area may have the unfortunate impact of actually increasing risk in another area. Further reverse or wrong way risk may not be fully appreciated.

Another problem is that the CRO is then rarely in a position to effectively implement consistent enterprise risk management (ERM). Fully fledged ERM is a clear requirement arising from recent Basel announcements, but should have been required regardless of any such pronouncements. The need to measure all risk on a complete and consistent basis has always been there. The problem is that with the CRO perhaps not being comfortable in all areas of risk there can be a developing silo culture. This was exacerbated by the BIS rules requiring capital calculation based separately on credit, market and

operational risk – with liquidity, strategic and reputational risk delegated to Pillar 2. This resulted in an undue focus on a sub set of the risk universe with, as we have seen, and previously predicted, disastrous consequences.

> The Risk Department under the management of the CRO is entrusted with developing an environment consistent with prudent risk taking.

The Role of the Board

Risk management is the responsibility of the Board. Again this has appeared explicitly within Basel 3, for example, but was always the case. It is the Governing Body that takes responsibility for the activities of the business, delegating but not abrogating as necessary.

Too many Boards have not actually understood what this really means. They too have limited understanding of what Risk Management really is and what it should do. If you are within a single institution you know how things are done where you are. You know how you do things – but do you know how you should do things? How would you know that what you are looking at is sub-optimal? Of course they will ask the CRO, but as we have seen they may have hidden shallows and consequently not have the ability to provide answers to all of the questions that could be asked.

Increasingly it is important for Board's to possess non-executive directors with appropriate risk skills to enable detailed and significant questioning of the CRO and business management to take place. From our experience few firms have grasped this obvious structural improvement and we have to date placed few risk non-executives within banks. The addition of a non-executive director with risk experience from other institutions would add significantly to the quality of debate on many boards.

The next problem for the Board is the problem if dealing with the future when the present is so complex. Shareholders and markets are clearly focussed on short term expectations which are impacted by the occurrence of what might be called non-goal correlated events. These events cause a divergence from anticipated results that may impact the career prospects of the Board themselves – but such events have occurred. The role of Risk Management is to develop a structure of systems and controls such that the likelihood of such events is reduced and their impacts mitigated where possible. This means that Risk Management and the CRO are often talking about things that might happen at some stage in the future (for example, the collapse of the Euro) when there are a series of risks which are much more likely that are poorly managed.

To make matters worse the CRO cloaks himself in what a cloak of false confidence believing in the sanctity of risk models and providing their output to the Board as if it is a mantra that must be understood. Combining the indigestible with the incomprehensible ensures that the appropriate level of discussion does not occur. The Board focussing on the here and now will delay their consideration of the Risk Management information and consequently fail to provide the necessary level of oversight that is both required and envisaged.

The Problem of Risk Management Itself

Is risk management itself the problem? Some consider that an industry has been developed that has no clothes. It is found wanting whenever there is a problem. Of course the CRO will say that it is not the concept that is at fault but the way that it has been implemented. But there are problems with risk management and these do need to be recognised.

The first issue relates to the need for consistent ERM as referred to previously. This needs a risk vision which will then be implemented throughout the business using policies such as risk appetite, risk reporting and risk acceptance. Yes there will be significant modelling but the concepts themselves need to be simple and easy to implement. Such modelling needs to be consistent with the risk vision such that the impact of events can be properly appreciated. CROs do themselves little service by stating the impact of such and such an event on credit risk is £x without being able to evaluate the total potential loss on the business.

Another issue relates to modelling. In the last 10 years or so modelling has been a major driver within risk management. It is prevalent in both credit and market risk and increasingly seen in counterparty credit risk, operational risk and liquidity risk. Strategic risk and reputational risk are still rarely modelled or measured even though appropriate techniques do exist to do so. To make matters worse much of the modelling that is conducted is at best unhelpful. We shall consider this further in the next section.

A final issue relates to what the Risk Department is actually trying to do. Most risk functions focus on two things – events that have occurred and unlikely but plausible events. This is like thinking that all that could happen to your car is a minor scratch or its complete destruction. Any number of events could occur and each requires different mitigating action. By focussing on events that have occurred the CRO is dragged into the day-to-day and its impact on budgeting and pricing. By then looking at the plausible but unlikely they are providing the Board with information that relates to an event that the Board do not think will occur. Of course the unlikely event that will occur is unlikely to be the one that has been looked at.

Risk Management is about looking at the distribution of risk from an area from expected to unexpected and everything in-between. It is as important to not over action a minor issue as to under action a major issue. Too many firms in my opinion completely miss the point of stress testing and such problems also exist with certain of the so-called risk advisory firms.

What Makes a Chief Risk Officer Great?

The Problem with Models

Any model that is being used within a bank needs to have good predictive ability. It needs to inform management about the nature of some form of risk and lead to some form of action plan. Different problems exist with different risk types and even some of the market standard modelling approaches are currently ineffective. To make matters worse the CRO often provides data to the Board to a level of accuracy that the modelling does not deserve. Showing decimal places when the data could be 20% wrong in either direction makes no sense at all. Just because you have a calculation to four decimal places does not mean that this makes any sense at all.

In credit risk we are living in volatile times, which I am sure everyone recognises. This has the consequential impact that next year's credit losses are unlikely to be based upon those incurred last year or in any prior year. This means any credit modelling system based on the use of historic data is unlikely to have good predictive ability and is likely to fail the required model validation test. Further we have even seen firms using corporate credit modelling systems that are based upon historic data for a different market, for example the USA. The rules and clear and it is actually also common sense. The model needs to be based on information relevant to that on which it is to be used. Such external models are of course of interest, but their ultimate value is limited.

If you are using a credit scoring system then the changing credit environment means that the model needs to be recalibrated and revalidated to ensure that it does indeed have a complete set of attributes. The validation needs to be conducted by ensuring that the model actually calculates correctly – it is clearly inappropriate to try to test one bad model by using another bad model. Again we are seeing both banks and their so-called advisors make such elementary errors.

In market risk the changed market conditions invalidate much of the modelling that has been conducted. We are now in an interest rate environment where the expectation is that the year-on-year interest rate movements will be upwards. The problem for the market risk modellers is that all of their quality relates to market where the year-on-year interest rate expectations were for rate reductions. In the absence of quality data the creation of synthetic data creates a level of uncertainty which is poorly understood. Basically many of the market risk modellers currently in regular usage would again fail an appropriate model validation approach. We have seen, for example, firms taking options pricing from 12 systems, ignoring the top and bottom 4 an then averaging the remaining approaches. There is a technical answer to this: rubbish!

The weakness continues in operational risk where banks should be attempting to estimate the level of loss that they are expecting for next year. That is quite different to the cost centre accounting that they seem to be undertaking. I could go on – but the concerns are clear. The modelling is not only inconsistent between risk types it is actually weak in most areas. The consequence of this is that there must be less reliance placed on models by the Risk Department, Board and of course the CRO. There is a need to a return to true risk management.

The Perfect CRO

The perfect CRO needs to have the trust of their Board and have the ability to interpret, explain and act. They need to have equal knowledge of all risk types and of accounting so that they can appreciate the impact on actual results. They need to understand compliance and mathematical modelling which needs to be combined with detailed knowledge of the industry in which they are working.

They need to be motivational in terms of their own team, the Board and the business to ensure that the risk culture and solutions are both embedded and effective. They need to be a good communicator, delegator and prioritisor. **Basically they need to be superman. Any takers?**

The author invites feedback and comments.
DWC@riskrewardlimited.com

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