



# Who Will Want to be a Compliance Officer?

## Also in this issue

- Trying to Improve Corporate Governance
- So Who Needs Technical Due Diligence?
- The Changing World of Political Risk
- What Happened to Risk Management?
- What is Risk Appetite?

## Dear Subscriber

Nobody reading this newsletter will be in the world that they bought into. The 1980s promise was of a world where there was peace, certainty and increasing prosperity. This is not the world we are now living in and some of the challenges posed by this environment are addressed in this issue. We are all aware of the increased global tensions resulting from a combination of regime change and terrorist activity, of large numbers of people migrating for either economic or safety concerns. At the same time the regulators are still seeking to enhance global regulation making banks and other financial service market participants safer so that the public can have more confidence in them. The Basel 3 rules which we are all familiar with are still being enhanced with Basel 4 being actively discussed albeit that at present it is really just adding some elements of Basel 2.5 into Basel 3.

The question for risk managers is what this is all likely to mean in the longer term. If you tie up the financial system with a requirement to hold a large amount of capital and liquidity then this without doubt prevents them from doing their job. The key role of a bank historically was to cycle excess personal and corporate cash to those that require those funds. Clearly if the banks are required to hold these funds as either liquid assets or to support capital requirements then they are unable to undertake their fundamental role. In previous issues of this journal we noted that this was likely to reduce global business activity. However there is another issue. As we leave an economic trend there is always going to be uncertainty. I am not going to predict at this stage when interest rates will begin to rise, saving that for the next issue. What is clear is that when there is the end of a trend which in this case has run since 1982, there is uncertainty and a paucity of information available to support decision making. Uncertainty as we have said before is the enemy of global growth and the friend of unrest.

In this issue we look at the impact on various parts of the business of these changes and in particular the roles of governance and compliance. It is important to emphasise we are not saying that bad practices have not occurred in the financial industry. They appear to occur in many industries from football to automobiles. What is clear to us is that the financial infrastructure is the oil that allows the engine of the economy to operate. If regulators continue to ration the availability of the oil then this will undoubtedly result in increased unemployment and unrest. We hope that at some stage regulators understand the need to develop a regulatory structure to support the growth and peaceful society agenda. At present we do not have this.

Best wishes,



Dennis Cox BSc, CFSI, FCA  
Chief Executive Officer



Index	PAGE
Who Will Want to be a Compliance Officer?	3
Trying to Improve Corporate Governance	5
So Who Needs Technical Due Diligence?	11
The Changing World of Political Risk	14
What Happened to Risk Management?	16
What is Risk Appetite?	19



### PLEASE CIRCULATE TO:

- Chief Risk Officer
- Head of Risk Management
- Head of Human Resources/LPD
- Head of Internal Audit
- Head of Operations
- Head of ALM
- Head of Treasury



### TO THE EDITOR

Do you have risk issues in your organisation or region you would like to share?

Email your thoughts to the Editor at [editor@riskrewardlimited.com](mailto:editor@riskrewardlimited.com)

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# Who will want to be a Compliance Officer?

*You will all be well aware that the regulatory requirements are increasing in the financial services sector globally. Regulators appear to be implementing a ‘loser pays’ philosophy with ever increasing penalties being levied both on firms and individuals. Nothing in this article is looking at whether there has been a misdemeanour that requires such precipitous action, but instead we are focussing on the message that is being delivered and the consequences of these actions.*

Recent cases in both the UK and USA in particular are seeking to name and shame individuals. This has been a technique which has long been applied to the regulatory market, but the approach seems to be changing.

We have heard much about senior management responsibility and the role of the governance committees. Globally there are a series of actions taking place seeking to ensure that those tasked with managing the business take compliance seriously and receive evidence to show that they are conducting their work to the standards that are required. Clearly the first line of defence is responsible for managing compliance and senior management need to know that this is being undertaken effectively.

But we ask the question **“who will want to be a compliance officer?”** To this I could also add “who would want to be a risk officer?” or “who would want to be an internal auditor?”

In all of these cases a department is tasked with trying to get someone else to do something. Let us think about each of these three roles. The compliance officer cannot actually ensure that compliance is achieved. They do not hold every conversation at the firm nor deal with every message that is sent out. This is an unrealistic proposition. They interpret changing rules and regulations in terms of seeking to ensure that the firm is capable of complying and also should verify that the necessary controls have been implemented in the business.

Of course the monitoring of these controls on a day-to-day basis does not fall under the

perjure of the compliance department. This is the responsibility typically of the operations area reporting to some form of Chief Operating Officer and ultimately to the governing committee of the firm. The compliance officer has no protection and you might distinguish this by contrasting the position of the Money Laundering Reporting Officer who does have a prescribed role with protection. The compliance officer if they disclose has no protection other than the whistle blowing legislation. This brings me to recent cases in the UK and the USA which have a common thread. Again I do not want to go into any depth regarding either case but in two cases the compliance officer has been penalised and in one of these the internal auditor was also penalised. What these cases have in common is that no other members of staff or senior management were criticised at any time.

**Can this be right?** The compliance officer reports to the senior management who also are responsible



Who will want to be a Compliance Officer?

for their pay and rations. Some senior management interpose themselves between the compliance officer and the firm and we have heard of a number of compliance officers who are put into a difficult position. What should they do if they are under pressure from the senior management team to not disclose something to the regulator? Regulators will tell you that immediate reporting is clearly the order of the day – but is that realistic and fair?

If the governing body of a firm tells a compliance officer to delay or avoid reporting something then the compliance officer has two choices. Either they can report and be dismissed by the firm or they can resign and report. Both are problematical for the individual. If they are dismissed they will have a problem getting a reference for their next role. Likewise if they resign they will also find it almost impossible to get a reference from the previous employer. If you are seeking to employ a compliance officer would you make your first choice someone that has either been dismissed by their firm or resigned and reported to the regulator? Would you believe them?

The consequence of this is that compliance officers are actually put into an invidious position. They are almost damned if they do and damned if they do not. Surely in all such cases senior management should be seen as having the primary responsibility unless it can be seen that the compliance officer wilfully disregarded their instructions and caused a breach on their own behalf.

My concern is that the balance of reward and risk have now become unbalanced and individuals will become increasingly concerned at becoming compliance officers. Many of the better people are likely to wish to leave the profession perhaps becoming consultants or trainers. We are seeing such people approaching our firm due to these concerns.

So if you are a compliance officer, what should you do? I am not sure how many of the following actions are feasible or even possible, but they need to be borne in mind.

1. Annually you should get the governing committee of the firm to commit that they are responsible for ensuring that the firm complies with all of its rules and regulations and that this is not the responsibility of the compliance officer.
2. The employment contract of the compliance officer should expressly include the statement that the compliance officer is under a duty to deal openly with their regulators and that this could include reporting matters to the regulator which have not been fully discussed or been approved by management. Such disclosure unless manifestly negligent should not form the basis for any form of retribution against the compliance officer.
3. The compliance officer should meet regularly with both risk and internal audit probably in tripartite meetings which are duly minuted to ensure that the full picture of concerns are communicated to all of the parties concerned.
4. Clearly compliance officer insurance is required. In the recent cases it does appear that

the compliance officer has been held out to dry. Without such insurance the costs of defending the case become exorbitant.

5. The compliance officer should consider making greater use of outsourced services. If you have hired a external firm to provide you with reporting it will be harder for the regulator to come after you so long as the selected firm is adequately staffed with quality personnel.
6. Finally you should keep records of all of your meetings with senior management and the regulator. Draft notes and send them to the party concerned to document what was discussed, disclosed and the actions to be taken by which party. In that way your good work is being recognised.

**But on balance would I recommend you becoming a compliance officer? In my opinion the salaries do not compensate adequately for the level of personal risk that is being taken so accordingly I would view this as a balanced decision.**



# Trying to Improve Corporate Governance

In July 2015 the Bank for International Settlements reissued its paper *Corporate Governance Principles for Banks* (paper d328). This sets out the various principles that banks need to cover. As always there is a lot in a BIS paper so in this article Global Risk Update Chief Editor, Dennis Cox highlights some of the key issues that are likely to be of interest.

## Principle 1: Board's Overall Responsibilities

**The Board has overall responsibility for the bank, including approving and overseeing Management's implementation of the bank's strategic objectives, governance framework and corporate culture.**

The paper refers to a "duty of care" and a "duty of loyalty". These are defined as follows:

### **duty of care**

*The duty of board members to decide and act on an informed and prudent basis with respect to the bank. Often interpreted as requiring board members to approach the affairs of the company the same way that a "prudent person" would approach his or her own affairs.*

### **duty of loyalty**

*The duty of board members to act in good faith in the interest of the company. The duty of loyalty should prevent individual board members from acting in their own interest, or the interest of another individual or group, at the expense of the company and shareholders.*

This is significant since it is placing the duty on the Board members apparently individually. Consequently where Board members are representing a single shareholder, for example, it will be hard for them to show that they are meeting this duty of loyalty. The concerns are clear – officers are essentially custodians acting on behalf of all customers and exercising fiduciary responsibility. In practice this is likely to result in changes to some Board memberships with perhaps an increase in Board diversity resulting.

Among their other responsibilities, board members and senior management are expected to define conduct risk based on the context of the bank's business. The BIS note that cases of misconduct have been identified as stemming from:

- the mis-selling of financial products to retail and business clients;
- the violation of national and international rules (tax rules, anti-money laundering rules, anti-terrorism rules, economic sanctions, etc); and
- the manipulation of financial markets – for instance, the manipulation of Libor rates and foreign exchange rates.

It is clear from this that there is a greater expectation that the Board and senior management will be directly concerned with ensuring that the firm meet these obligations and this is likely to mean that in practice they receive greater information on actions being taken to ensure regulatory compliance.

The board should set the "tone at the top" and oversee management's role in fostering and maintaining a sound corporate and risk culture. Management should develop a written code of ethics or a code of conduct. Either code is intended to foster a culture of honesty and accountability to protect the interest of its customers and shareholders. This is clarified later in the paper as follows:

In order to promote a sound corporate culture, the board should reinforce the "tone at the top" by:

- setting and adhering to corporate values that create expectations that all business should be conducted in a legal and ethical manner, and overseeing the adherence to such values by senior management and other employees;
- promoting risk awareness within a strong risk culture, conveying the board's expectation that it does not support excessive risk-taking and that all employees are responsible for helping the bank operate within the established risk appetite and risk limits;
- confirming that appropriate steps have been or are being taken to communicate throughout the bank the corporate values, professional standards or codes of conduct it sets, together with supporting policies; and
- confirming that employees, including senior management, are aware that appropriate disciplinary or other actions will follow unacceptable behaviours and transgressions.

The paper specifically requires that they establish, along



## Trying to Improve Corporate Governance

with senior management and the CRO, the bank's risk appetite, taking into account the competitive and regulatory landscape and the bank's long-term interests, risk exposure and ability to manage risk effectively.

Also within this principle Boards are required to:

- oversee the bank's approach to compensation, including monitoring and reviewing executive compensation and assessing whether it is aligned with the bank's risk culture and risk appetite; and
- oversee the integrity, independence and effectiveness of the bank's policies and procedures for whistleblowing.

The role of the remuneration committee as a sub committee of the Board is therefore clarified. Remuneration is a Board responsibility conducted on its behalf by the remuneration committee.

In another article we consider some recent compliance cases where action has been taken against compliance officers. In the light of these key requirements we would expect action to be taken against officers of the bank prior to action being taken against compliance staff.

Still within Principle 1 there is a discussion of risk appetite. Again this is within another article in this Update. However the specific requirements are as follows:

The bank's Risk Appetite Statement (RAS) should:

- include both quantitative and qualitative considerations;
- establish the individual and aggregate level and types of risk that the bank is willing to assume in advance of and in order to achieve its business activities within its risk capacity;
- define the boundaries and business considerations in accordance with which the bank is expected to operate when pursuing the business strategy; and
- communicate the board's risk appetite effectively throughout the bank, linking it to daily operational decision-making and establishing the means to raise risk issues and strategic concerns across the bank.

This is still in our opinion a little confused and fails to actually assist firms with the implementation challenges which clearly will occur. Later in this Update we explain what risk appetite really means leading to a more acceptable and appropriate solution.

Principle 1 is a complex principle in the way it includes so many different issues. Thankfully many of the subsequent Principles are more straightforward.

### **Principle 2: Board qualifications and composition**

**Board members should be and remain qualified, individually and collectively, for their positions. They should understand their oversight and corporate governance**

**role and be able to exercise sound, objective judgment about the affairs of the bank.**

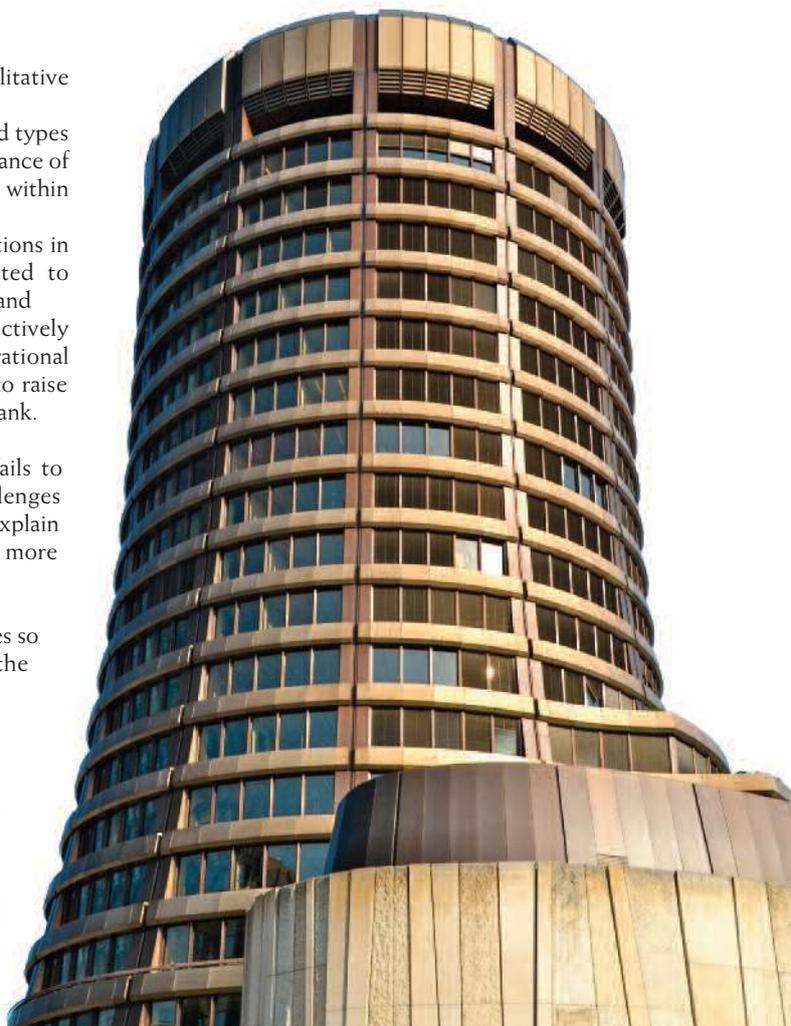
This has been carried forward from previous versions of the Principles. There needs to be sufficient independent directors who are free from bias. Individuals need a balance of skills, diversity and expertise with the Board collectively possessing necessary qualifications commensurate with the size, complexity and risk profile of the Bank. This is actually a little softer than the requirements being promulgated in Europe which required more of individuals.

The specific relevant areas of competence highlighted may include, but are not limited to capital markets, financial analysis, financial stability issues, financial reporting, information technology, strategic planning, risk management, compensation, regulation, corporate governance and management skills.

The remainder of the detail under this Principle essentially repeats previous papers.

### **Principle 3: Board's own structure and practices**

**The board should define appropriate governance structures and practices for its own work, and put in place the means for such practices to be followed and periodically reviewed for ongoing effectiveness.**



## Trying to Improve Corporate Governance

What is being requested is that Boards review whether their structure remains suitable for the business and regulatory environment. Too often structures have been developed over time without the necessary time being spent to ensure that they continue to be effective. Often we find that it is the failure of the corporate structure that leads to the problems faced in practice. The requirements are detailed and specific. They state the following:

To support its own performance, the board should carry out regular assessments – alone or with the assistance of external experts – of the board as a whole, its committees and individual board members. The board should:

- periodically review its structure, size and composition as well as committees' structures and coordination;
- assess the ongoing suitability of each board member periodically (at least annually), also taking into account his or her performance on the board.
- either separately or as part of these assessments, periodically review the effectiveness of its own governance practices and procedures, determine where improvements may be needed, and make any necessary changes; and
- use the results of these assessments as part of the ongoing improvement efforts of the board and, where required by the supervisor, share results with the supervisor.

The suitability assessments are particularly relevant for the independent non executive directors to ensure that they remain independent and effective. Generally we would expect an independent firm to be appointed to conduct this work and our firm has fulfilled this role multiple times.

There is then the following interesting statement. "The board should maintain appropriate records (eg meeting minutes or summaries of matters reviewed, recommendations made, decisions taken and dissenting opinions) of its deliberations and decisions. These should be made available to the supervisor when required."

Too often dissenting statements are not minuted. It is clear from this that the expectation is that such statements will in future be minuted.

The requirements of the Audit Committee which appear in BCBS 280 also appear here as follows:

The Principle states that the audit committee is, in particular, responsible for:

- framing policy on internal audit and financial reporting, among other things;
- overseeing the financial reporting process;
- providing oversight of and interacting with the bank's internal and external auditors;
- approving, or recommending to the board or shareholders for their approval, the appointment, remuneration and dismissal of external auditors;
- reviewing and approving the audit scope and frequency;
- receiving key audit reports and ensuring that senior

management is taking necessary corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations, and other problems identified by auditors and other control functions;

- overseeing the establishment of accounting policies and practices by the bank; and
- reviewing the third-party opinions on the design and effectiveness of the overall risk governance framework and internal control system.

The Risk Committee is also discussed and it now appears as a key required committee. In terms of their role the risk committee should:

- be required for systemically important banks and is strongly recommended for other banks based on a bank's size, risk profile or complexity;
- be distinct from the audit committee, but may have other related tasks, such as finance;
- have a chair who is an independent director and not the chair of the board or of any other committee;
- include a majority of members who are independent;
- include members who have experience in risk management issues and practices;
- discuss all risk strategies on both an aggregated basis and by type of risk and make recommendations to the board thereon, and on the risk appetite;
- be required to review the bank's risk policies at least annually; and
- oversee that management has in place processes to promote the bank's adherence to the approved risk policies.

This is quite a change with the requirements for independent directors to be the majority being a major shift. Where these are all coming from may be a difficult question to answer!

Other specialised committees that are recommended include:

- **Nomination / human resources / governance committee:** provides recommendations to the board for new board members and members of senior management. The nomination committee should analyse the role and responsibilities of the board member and the knowledge, experience and competence which the role requires. Where a supervisory board or board of directors is formally separate from a management board, objectivity and independence still need to be ensured by appropriate selection of board members. The nomination committee should strive to ensure that the board is not dominated by any one individual or small group of individuals in a manner that is detrimental to the interests of the bank as a whole. It may be involved in assessment of board and senior management effectiveness and may be involved in overseeing the bank's personnel or human resource policies (see Principle 2).
- **Ethics and compliance committee:** ensures that the bank has the appropriate means for promoting proper

## Trying to Improve Corporate Governance

decision-making, due consideration of the risks to the bank's reputation, and compliance with laws, regulations and internal rules.

### Principle 4: Senior management

**Under the direction and oversight of the board, senior management should carry out and manage the bank's activities in a manner consistent with the business strategy, risk appetite, remuneration and other policies approved by the board.**

Much of the detail here repeats previous standards. There is however a slight enhancement in reporting expectations as follows:

Senior management should provide the board with the information it needs to carry out its responsibilities, supervise senior management and assess the quality of senior management's performance. In this regard, senior management should keep the board regularly and adequately informed of material matters, including:

- changes in business strategy, risk strategy/risk appetite;
- the bank's performance and financial condition;
- breaches of risk limits or compliance rules;
- internal control failures;
- legal or regulatory concerns; and
- issues raised as a result of the bank's whistleblowing procedures.

Notice that the obligation is on the Board rather than committees of the Board so this could result in additional reporting of detail to the Board. I would recommend that the greater detail be available and key messages be summarised for the Board to consider. Again reporting needs to be consistent with risk appetite expectations to prevent time being wasted on immaterial matters.

### Principle 5: Governance of group structures

**In a group structure, the board of the parent company has the overall responsibility for the group and for ensuring the establishment and operation of a clear governance framework appropriate to the structure, business and risks of the group and its entities. The board and senior management should know and understand the bank group's organisational structure and the risks that it poses.**

The detailed analysis of this principle focuses on parent and subsidiary boards together with opaque structures. There is little that is new here however they do clarify responsibilities of senior management and the board, as appropriate noting that they should be cognisant of the challenges and take action to avoid or mitigate them by:

- avoiding setting up complicated structures that lack economic substance or business purpose;
- continually maintaining and reviewing appropriate policies, procedures and processes governing the approval and maintenance of those structures or

activities, including fully vetting the purpose, the associated risks and the bank's ability to manage those risks prior to setting up new structures and initiating associated activities;

- having a centralised process for approving the creation of new legal entities and subsidiaries based on established criteria, including the ability to monitor and fulfil each entity's regulatory, tax, financial reporting, governance and other requirements and for the dissolution of dormant subsidiaries;
- establishing adequate procedures and processes to identify and manage all material risks arising from these structures, including lack of management transparency, operational risks introduced by interconnected and complex funding structures, intragroup exposures, trapped collateral and counterparty risk. The bank should only approve structures if the material risks can be properly identified, assessed and managed; and
- ensuring that the activities and structure are subject to regular internal and external audit reviews.

### Principle 6: Risk management function

**Banks should have an effective independent risk management function, under the direction of a chief risk officer (CRO), with sufficient stature, independence, resources and access to the board.**

The paper notes that the Key activities of the risk management function should include:

- identifying material individual, aggregate and emerging risks;
- assessing these risks and measuring the bank's exposure to them;
- subject to the review and approval of the board, developing and implementing the enterprise-wide risk governance framework, which includes the bank's risk culture, risk appetite and risk limits;
- ongoing monitoring of the risk-taking activities and risk exposures in line with the board-approved risk appetite, risk limits and corresponding capital or liquidity needs (ie capital planning);
- establishing an early warning or trigger system for breaches of the bank's risk appetite or limits;
- influencing and, when necessary, challenging decisions that give rise to material risk; and
- reporting to senior management and the board or risk committee on all these items, including but not limited to proposing appropriate risk-mitigating actions.

The issue of independence is discussed. Recently we have seen a number of risk functions which have been embedded within business units. This is clearly not an ideal situation and the BIS state that while it is common for risk managers to work closely with individual business units, the risk management function should be sufficiently independent of the business units and should not be involved in revenue generation. Such independence is an essential component of an effective risk management function, as is having access to all business lines that have the potential to generate

## Trying to Improve Corporate Governance

material risk to the bank as well as to relevant risk-bearing subsidiaries and affiliates.

The paper goes on to discuss the role of the Chief Risk Officer (CRO) although this repeats material previously issued.

### **Principle 7: Risk identification, monitoring and controlling**

**Risks should be identified, monitored and controlled on an ongoing bank-wide and individual entity basis. The sophistication of the bank's risk management and internal control infrastructure should keep pace with changes to the bank's risk profile, to the external risk landscape and in industry practice.**

At this point it is probably worth reminding you that this is a corporate governance paper and not a risk management paper. There are a lot of sound practices papers governing risk management already in issue and this paper does to some extent reiterate key elements. That so much of this paper addresses risk highlights the importance of this issue to Boards and their memberships.

Because it was the operational risk sound practices paper which introduced many key risk building blocks too often risk functions delegated risk identification to the operational risk function. This paper makes it clear that risk identification needs to cover all risks. The importance of stress testing is again emphasised although there is a separate sound practices paper on this specific issue. This paper emphasises the role of the Board as follows:

As part of its quantitative and qualitative analysis, the bank

should utilise stress tests and scenario analyses to better understand potential risk exposures under a variety of adverse circumstances:

- internal stress tests should cover a range of scenarios based on reasonable assumptions regarding dependencies and correlations. Senior management should define and approve and, as applicable, the board should review and provide effective challenge to the scenarios that are used in the bank's risk analyses;
- reverse stress testing could provide additional insight into the risk position of the bank as well as potential future management actions;
- stress test programme results should be periodically reviewed with the board or its risk committee. Test results should be incorporated into the reviews of the risk appetite, the capital adequacy assessment process, the capital and liquidity planning processes, and budgets. They should also be linked to recovery and resolution planning. The risk management function should suggest if and what action is required based on results; and
- the results of stress tests and scenario analyses should also be communicated to, and given appropriate consideration by, relevant business lines and individuals within the bank.

### **Principle 8: Risk communication**

**An effective risk governance framework requires robust communication within the bank about risk, both across**



## Trying to Improve Corporate Governance

the organisation and through reporting to the board and senior management.

Requesting dynamic forward looking reporting there is little that is new here.

**Principle 9: Compliance**

**The bank's board of directors is responsible for overseeing the management of the bank's compliance risk. The board should establish a compliance function and approve the bank's policies and processes for identifying, assessing, monitoring and reporting and advising on compliance risk.**

Of course compliance risk within the BIS framework is an element of operational risk albeit that reputational risk is a separate risk category. The paper requires that the compliance function be independent from management to avoid undue influence or obstacles as that function performs its duties. It states that the compliance function should directly report to the board, as appropriate, on how the bank is managing its compliance risk. Again as mentioned later in this paper it can be senior management that directs compliance to do the wrong thing and then of course a whistleblowing charter is required even though the compliance officer may never work again.

**Principle 10: Internal audit**

**The internal audit function should provide independent assurance to the board and should support board and senior management in promoting an effective governance process and the long-term soundness of the bank.**

Again there is a separate sound practices paper on internal audit in banks so was this really required? By including it here at least the BIS are emphasising its importance.

There is nothing here that had not already been issued by the BIS.

**Principle 11: Compensation**

**The bank's remuneration structure should support sound corporate governance and risk management.**

This reiterates what appears in Principle 1 and other papers. It specifically states that remuneration should reflect risk-taking and risk outcomes. Practices by which remuneration is paid for potential future revenues whose timing and likelihood remain uncertain should be carefully evaluated by means of both qualitative and quantitative key indicators. The remuneration framework should provide for variable remuneration to be adjusted to take into account the full range of risks, including breaches of risk appetite limits, internal procedures or legal requirements.

**Principle 12: Disclosure and transparency**

**The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.**

Much of this repeats what appeared earlier in the paper and none of this is new.

Now for the supervisors:

**Principle 13: The role of supervisors**

**Supervisors should provide guidance for and supervise corporate governance at banks, including through comprehensive evaluations and regular interaction with boards and senior management, should require improvement and remedial action as necessary, and should share information on corporate governance with other supervisors.**

And that is it. There is a change of emphasis in some areas and a restatement of various obvious matters but it is perhaps in the review and organisation of the Board that the main changes exist together with the changing skills requirements. We expect Boards to require more risk based professionals as independent members and are already supplying such individuals as required.





## So Who Needs Technical Due Diligence?

- Lack of quality assurance systems or a failure to exercise proper quality control;
- Poor contractual arrangements as between professional and/or constructors and the project developers limiting scope of work and necessitating contract amendments and change orders, resulting in delays and increased costs;
- Non-compliance with environmental standards, health and safety regulations and labour laws, leading to fines, accidents, claims for damages and even suspension of development or operations;
- Occurrence of unforeseen or external events perceived as unlikely materialising, adversely affecting revenues or costs;
- Changes in market conditions, including adverse publicity or disruption from supplier or customer action, affecting either or both supply and demand for a project's outputs.

Clearly in the event of failure of a project backed by project assets the funder is protected from total financial loss, although depending on realisations it may bear some loss on any element of the funding that is unsecured. However, it is possible that the value of the security itself may be eroded by the problem causing the project's demise eg if a site over which

the funder has a charge proves to be more seriously contaminated than anticipated and needs extensive and costly remediation before development can take place.

Brownfield sites can often have "negative values" and indeed, there are situations where a liability for remediation can attach to the funder if it assumes title to a problem asset in any recovery situation. Taking over a half completed project, or even a completed project, that for any reason has been abandoned is of no value to a funder unless there is a commercially viable alternative use.

If a funder becomes associated with a project that fails spectacularly or has infringed responsible ethical, environmental or social standards, it may be able to recover its investment or loan but could suffer a loss of reputation and, as a consequence, a loss of potential future business. Further, if physical or economic damage has been caused to a third party by the project or its outputs, a funder may be liable in whole or part if it is deemed to have exercised control or significant influence on the management of the project under the terms of the funding agreement or its staff or representatives sit on the management board.

To illustrate aspects of these problems we cite two examples of projects in the

public domain where funders have incurred losses because technical risks, which in these cases were brought to their attention, were dismissed for political reasons. The first is the pUBLIC, a multi-purpose "international" community arts centre in West Bromwich, a facility that was intended to catalyse regeneration in this struggling Midlands town located between the two larger cities of Birmingham and Wolverhampton.

Originally estimated to cost £17 million, both the fitness for purpose of its design and its buildability were questioned. The project was eventually delivered after years of delay at an outturn cost of £72 million. After receiving an operating subsidy from the local authority of £2 million per annum it ceased to trade in 2013 after just 4 years. The building stands vacant without an alternative use.

The second example is the Turner Gallery of contemporary art in Margate. This project was to be constructed in the tidal zone off the pier so that the views that inspired the artist JM Turner could be recreated. For fairly obvious reasons, few if any fixed structures have been built in a tidal zone, but the design and procurement under a two stage design and build process was progressed to a point where a contractor was asked to commit to a fixed price. That price was more than three times the original



## So Who Needs Technical Due Diligence?

estimate and the project was then aborted and the costs to date written off. A gallery was eventually constructed on terra firma.

A happier outcome was achieved in respect of the airport hotel at the New Athens Airport. The original design was for a five star property incorporating traditional Greek architecture - columns, fountains, statues and marble floors - on that basis that, as the first building visitors would see on arrival and the last they would see on departure, the Government wanted it to be "iconic". Due diligence consultants reported that most users of airport hotels stay for less than 8 hours and have little interest in the exterior of such hotels so the Airport PPP company accepted that the design concept had to be rethought. The result was a five star fit out and operation housed in a two star building, compatible with the terminal. It is now operating successfully as a Sofitel brand.

It should be emphasised that the objective of technical due diligence is not to redesign or re-engineer a project. Rather it is simply to review the proposals put forward together with the background studies, assess the risks of its deliverability and sustainability in as constructive a manner as possible and report accordingly. Typically the scope of a technical due diligence assignment covers the following aspects of a project:-

- Business Plan, setting out the key objectives of the project, the market opportunity, the economic and technical principles underlying the project, outcomes and measures of success (key performance indicators);
- The Project Team, the basis on which it has been assembled, the experience in advising on projects in the relevant sector and exhibiting similar issues of the professional firms selected and of the individuals who will be involved, references, where applicable, and how their respective inputs will be co-ordinated;
- The Project Site, examining the accessibility of the location and surrounding areas, geo-technical characteristics, environmental and ecological constraints, archaeological history and, if existing buildings and structures on the site are to be retained in the project, their condition and work required for their refurbishment;
- The Design and Engineering, examining the design development process, fitness for purpose of the designs and specifications per the business plan and brief, their integrity and the identification of key issues yet to be resolved, including the use of non-standard materials and equipment or long lead times;
- Procurement of contractors, the tender process including pre-qualification and selection, contract form, relevant experience of the contractors and references, where applicable, labour and financial resources;
- Programme, examining the reasonableness of the projected time pre-contract to secure appointments and consents and design development and the comprehensiveness of construction tasks identified and reasonableness of the time allowed for their execution;
- Planning and Statutory Consents, reviewing the likelihood of consents being granted and the conditions under which it may be from relevant correspondence with the various authorities or examining the practicability of the actual conditions imposed where consents have been granted, including financial contributions to community infrastructure schemes negotiated and/or levied;
- Building Control and Health and Safety Regulations, reviewing the general and particular requirements for the project as advised by those responsible for certification;
- Third Party Rights, reviewing the need for the developer to obtain agreements on party walls, rights to light, air rights, riparian rights as necessary and that adequate cost provision is made;

- Insurances, ascertaining that relevant professional indemnity, contractor insurances and employers liability insurances are in place, are current and that cover is commensurate with the size and complexity of the project;
- Collateral warranties ensuring that the design team and the contractors provide enforceable warranties in a suitable form to indemnify the funders if they are responsible for any unsecured losses;
- Construction Budget, reviewing the cost plan to establish that it is comprehensive, based on current labour and material prices and that the degree of cost certainty is in line with the relevant design stage;
- Development Appraisal, demonstrating viability, projecting values and costs, examining cash flow projections and applying sensitivity analysis enabling quantification of the impact of any key risks identified;

The above is necessarily a general summary of what may be required by funders but, in any event, instructions will vary considerably as between cases. Funders may restrict technical due diligence to particular areas of concern, they may call for a review at each of the design development stages and only agree to fund the following stages if they are satisfied that the project is progressing satisfactorily and they may instruct due diligence advisers, whether in house or external, to monitor progress through the construction phase (and even beyond into the operational phase).

It will also be apparent from the above that, although their focus will be different, there is an element of overlap between technical, legal and financial due diligence. Funders expect due diligence advisers to work closely together, share information and conclusions, and ideally provide them with clear unequivocal opinions that are complementary and consistent with each other.

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# The Changing World of Political Risk

*Risk Reward Group CEO Dennis Cox, BSc FCA CFSI, is a global banker, Big Four chartered accountant, risk management and bank internal audit specialist, as well as an international lecturer and noted published author. Here he ponders the changing world of political risk.*

From even a cursory view of the news you will see that we are living in what might be easily referred to as interesting times. A thought process which followed the end of hostilities after the so called World War 2 has broken down. Changing politics in countries as diverse as the UK, USA, Australia, Greece, Russia and much of the Middle East render political risk of much greater importance than has ever been the case before.

For us political risk means trying to understand what the political undercurrent is and to try to ride it as best you can. This impacts all companies and individuals since political risk can make a significant difference to the opportunities and threats that will exist in the future. This means that firms will need to change their strategies in the light of such challenges and individuals alter their investment approaches and wealth expectations taking these changes into account.

In previous articles we have indicated that we are at the end of an economic cycle that started in 1946, peaked in 1982 and ended around 2008. We also indicated that when you leave an economic cycle this leads to uncertainty and unrest prior to the next economic sustainable trend commencing leading fairly naturally to an elongated period of growth – albeit with limitations. We also indicated that unrest and change whilst certain in general could not be predicted and that outcomes were likely to be surprising.

Political risk seeks to look into the impact of such changes in the political arena to enable readers to appreciate the impacts that such changes are likely to have upon their personal and corporate strategies. At its best it seeks to understand the economic and social changes that are occurring and synthesise these into a map of political uncertainty.

Some commentators suggest that uncertainty is a constant but this is clearly not the case. When you are at the end of a trend, the consensus that may have applied almost without question for many years no longer tends to remain valid. Not all parts of the global economy recognise this at the same time and the political impacts are generally both inconsistent and piecemeal. That is what is happening at present as harbingers of false dawns seek to lead minority aspirants to a non-existent promised land.

The problem with political risk is that it works primarily by analysing the status quo and then looking at a series of events that have previously occurred to consider their impact upon the current situation. However I have indicated that the current cycle started around 1946 and that this then would of course have followed a period of uncertainty. In reality this started around 1928 and only ended in 1946. It was a period of 18 years which included turmoil and major change. It was not an easy time to do business and hyperinflation and high unemployment were a continual curse.

So where are we at present? We are now in a world where the expectations are that at some stage interest rates will rise, although the date when this will occur is far from certain. Interest rate rising scenarios are generally negative economic cycles when it is difficult for growth to be achieved. Companies and countries contract and this has an impact on political



## The Changing World of Political Risk

movements. In a negative economic environment not all companies perform badly. Indeed some do very well, but these tend to be the minority rather than the majority. As interest rates rise there is generally a negative impact upon consumption which causes reductions in commodity prices and reduced inflation. This actually tempers the need for interest rate rises yet time and again we have seen our political masters making mistakes exacerbating a difficult situation.

Political risk is therefore heightened at present due to the lack of global growth, the collapse in commodity prices and the level of international unrest that is currently occurring. This is the point at which we and what might be termed traditional political risk diverge. It is our view that in most countries of the world totally unexpected outcomes can be expected. It is this that leads to the emergence of Donald Trump in the USA as a formidable force and the election of Jeremy Corbyn by the UK labour party. It leads to anti establishment parties being elected, an increase in nationalism and anti establishment personalities suddenly taking the reins of power.

### It doesn't work. It never works.

Unfortunately by the time people realise it cannot work there will have been significant damage wrought on the relevant economy. There can in some cases also be major international impacts. Inside this analysis the activities throughout the global environment do exhibit a commonality. Why this is able to occur is that it is actually a minority that are interested in politics in the first place. They are able to drive an agenda and actually stifle the majority. The majority view is rarely newsworthy and a soothsayer can sound pretty persuasive when whatever they say rarely matters. Then they suddenly have the levers of power without an ideology that could possibly work or the mechanisms to support their success.

However as I have said they are likely to take control. In my view at present this is more likely to be protectionist right facing political groupings than left wing, although in some cases left wing groups will take power but again they will generally last for little more than a year prior to their collapse.

A number of issues arise as a result of this analysis. Firstly it is clear that political risk becomes an increasing risk for firms and needs to be clearly addressed in their risk analysis. Advice needs to be gathered from multiple sources, not only regarding the home politics of the Head Office country, but also the secondary effects. Clearly any changes in the Chinese economy or the US economy impact upon companies in the UK, for example.

Secondly the firm needs to consider what changes are likely and which are plausible. Rising interest rates, for example are likely, whereas declining rates are plausible. Whilst rising rates tend to presage inflation, declining rates below zero generally lead to stagnation. Not great options really. In the financial services sector much of the product suite is dependent upon the state of the global and local economy

meddled by government policy. Rising taxation is the likely scenario with stagnant taxation being the plausible scenario. Rising capital requirements for banks are the likely scenario with even greater rising levels of capital and liquidity being the plausible option.

It makes life difficult for banks. At present banks are the whipping boys of the global economy. The mistakes that they have made have resulted in their being easy targets and in many cases their senior management have not conducted themselves with any credit. That such mistakes are continuing to occur is clearly a source for concern. However banks will need to think through what their role is likely to be in the on-going global economy. They will need to see where they will add value then stress test this through a series of political scenarios. This will look like this:

1. Assume that there is a left wing labor government in the UK and a right wing government in the USA with a protectionist regime in Russia and a reduced growth expectation for China
2. Assume that the EU breaks apart and there is further global unrest with oil prices dropping to \$24 per barrel and a general reduction in commodity prices and interest rates rising by at least 50% per annum.

Notice in these two scenarios there are a series of events that occur. In political risk it is not sensible to look at countries in isolation. They import and export, being part of the global economy. Consequently there tend to be multiple effects rather than single impacts and these need to be taken into account. One of the concerns that clearly exists is that stress testing is too focussed on a unitary concern and misses these composite issues which really cause the problems we see.

In terms of the regulatory structure there is no doubt in my mind that in the negative financial market we are moving into there is a need for a reduction in capital and liquidity rules to enable the financial community to undertake their roles with a likelihood of success. The enhanced capital will cause an increase in funding rates and create unemployment and a low growth economy. Of course bodies such as the Bank for International Settlements are not tasked with achieving growth. Rather they are seeking to avoid contagion.

What is certain is that the current direction of travel of global regulation will exacerbate political risk and will potentially result in series of unintended consequences which will benefit nobody.

the current direction of travel of global regulation will exacerbate political risk and will potentially result in series of unintended consequences

# What Happened to Risk Management?

*There has been a change in risk management. Perhaps we should have seen it coming. But perhaps that is the problem. Risk management no longer sees things coming. The key change is that it is acting more and more like a regulatory construct, like a compliance function. That is not its role and should not be seen as being enough. This article expands on the trends in risk management over the last 30 years and provides a series of potential actions that firms should take.*

## The Development of Risk Management

Risk management is not new. I am sure the Romans exercised some form of risk management as they developed their building plans for domination of the world as they knew it. In many industries risk management was firmly embedded into the fabric of the business. Industries such as pharmaceutical, oil and gas and engineering, for example, would all consider the risk of the actions that they were taking. This is due to the significance of the impact of failure on their brand.

If a drug sold by a reputable pharmaceutical company is found to be faulty this can result in major loss of life and a level of claim that would certainly breach the risk appetite of any firm. Such failures must not happen and the licensing rules for the industry ensure that the levels of testing that are undertaken are commensurate with ensuring that the

chance of such an event is significantly reduced. What might be considered as typical risk management is included within the regulations for the industry and so aligned to the reputational maintenance needs of the business that to ignore them would be considered completely unacceptable by both the management team, regulators and society at large.

For most of the last century techniques in this area have been

improving. Generally commencing in areas which surrounded process quality they were rarely bought together into a consistent format to implement what might now be considered as enterprise risk management. However these approaches did significantly enhance the brands of these firms through attempting to ensure product quality. In terms of codification of risk management into an industry with professional standards and standardised approaches much of this followed the development of the quality industry and associated methodologies. Rarely were risk managers titled as being “risk managers”. They were quality control officers and other similar sinecures.

In banking none of this happened.

## The Lag in Banking

In the 1970s we did have banking rules. Well sort of. Certainly there were licensing regimes in most



## What Happened to Risk Management?

countries. These set basic requirements to support the management of fiduciary responsibility. Compliance officers really started in the 1970s as requirements became slowly more complex, but the real growth in the industry did not start until the 1980s. With the development of rules by external parties as opposed to management seeing the need for the process and choosing to design the rules themselves we get a difference in approach.

In most industries management recognised that maintaining brand values meant you do not kill people unnecessarily (unless you are an army). This inextricably leads to some form of risk management being implemented regardless of what it is called. In the banking industry senior management were too busy just making money to see the need for unnecessary additional controls. At its most basic banking and insurance operated a different general control structure.

In common current parlance the three lines of defence model was only partially implemented. Remember the first line of defence are people that do things. They need to know what they should do and be trained to do it. They need generally to be cautious and careful being reprimanded if they do something wrong. The second line of defence is there to ensure the first line of defence is operating effectively.

It provides a level of control and monitoring to encourage the first line of defence to do the right thing. It neither replaces the first line of defence nor ensures that the first line of defence will not fail; instead it supports, monitors and informs. In business risk management was being developed in the second line and more importantly in the first line. In banking additional second line resources were often thought to be unnecessary and the industry incorrectly assumed that risk management was fully embedded within the first line of defence. It is only with hindsight that it became clear that this was not the case.

The development of internal audit as the third line of defence actually occurred over a similar period and paralleled these developments. The third line was normally an inspection process checking things management needed to have checked in the way they wanted them to be checked. In this case both the banking industry and other parts of the global community were actually acting in the same way. The development of a forward looking added value internal audit function again was a 1980s development which took hold at the end of the last century. Even now in some countries internal audit is still little more than inspection with all of the consequent negative connotations. And what about senior management and their need to have effective controls to ensure that their goals and missions were achieved? Again this is

1980s language and in terms of defence we know what most senior management were doing. They were sitting on it.

As the regulators in the banking industry increasingly required discrete rules to be implemented particularly in the 1980s and 1990s this resulted in the growth of the compliance function. Since many of these rules actually related to elements of risk management, this was increasingly seen as a regulatory construct and not something that truly added value to the firm.

Risk management within our industry was in its infancy.

But it was worse than that.

### The Development of Compliance and Risk

Even in compliance there was a quality problem. Where do you get compliance officers from? The legal functions of the banks were generally staffed by legally qualified professionals who understood certain elements of legal process and documentation. In some areas they would be extremely detailed in their knowledge whereas in others that would have what might be termed as "hidden shallows". What they generally did not know was how the bank

## What Happened to Risk Management?

operated and processed things. Accordingly they did not want to grab this new industry as being part of their own and kept well away.

The only answer that was left for the banks was to take people from the existing business and put them into compliance. Often these were either people that were not good at the job they were doing, heading towards retirement or had some form of perceived personality defect which meant their direct bosses were happy to recommend their transfer to this new area. Many of these people worked really hard to create their new world. Many of them were also unsuitable for this challenge. With elements of risk management being essentially delegated to a number of these compliance officers it is perhaps unsurprising that the business really operated in spite of their existence and very little real change happened. Internal audit had originally suffered with the same malaise although escaped earlier.

I recall one case from only seven years ago where in a major bank I was informed that "If you were no good at your job, or were physically or mentally disabled the obvious place to put you was internal audit." In that firm compliance did not even achieve that level of weakness.

If you place risk management into the arena of being a regulatory construct then clearly management will not take it seriously, building it into their strategy and daily way of doing business. With regret that is what happened.

### The Regulators Response

Again in the late 1970s regulators were increasingly concerned about the potential for banking failures. Interest rates were rising erratically to a peak in 1980 and massive volatility until the peak of 1982 and the subsequent decline.

As they became concerned they also realised that they did not have the right teams or rules either, so they often went outside to consultancy firms to develop their initial thoughts. These requests were to look at the areas where they were most concerned

and to develop guidance as appropriate for dissemination to the industry in draft. The first set of requests was typically in the area of lending and initial guidance was created. It was however guidance and the regulators hoped it would be taken into account but compliance with these rules was not compulsory. Worse still it was a single risk set – credit risk. This was the start of the risk silos which remain part of the problem.

With the regulators issuing this guidance of course many compliance officers grasped it. However some seeing that it was only guidance purely issued it around the business and thought that by doing so they had done something useful. Of course they had not.

### The Business Imperative

The 1980s was not an easy place for banks to make money. Interest rates on average were rising so their cost of funds was definitely increasing. Customers with long terms loans would sit on them since to refinance the loans would result in a increase in rates. The economy was difficult to manage particularly in the Western world. The inability to get long term finance constrained business growth. The unwillingness of people to move housing loans constrained their ability to acquire new property, slowed the property market and also resulted in an increase of unemployment with people stuck in negative equity in the wrong places. That was the business imperative at the time. Banks needed to see what was coming and what came was a secondary bank crisis of cascading failure.

For the first time there was a convergence of the needs of the senior management team and risk management leading to both the development of risk management teams and also risk management techniques such as interest rate swaps initially developed in the early 1980s. Only then do you really get the growth of risk management as a subject but again the problem of compliance was still there. Where do the staff come from that are needed for this new area? In many cases they took staff from compliance into these

new functions. Credit underwriting was clearly established so many firms took staff from there (or from credit administration) to staff these new business areas. The vision of enterprise risk management was still a long way away. For many firms it remains little more than an illusion now.

### And Today?

Now firms have large compliance departments as they continually are whipped by regulators on the loser pays principle. They have large internal audit functions which are risk based looking at areas such as efficiency for the first time (at least that is what the rules say). And of course they also have large risk management teams developing ICAAPs and ORSAs, Recovery and Resolution Plans, stress tests and ILAAs. They have models and mathematicians and they still operate in silos.

The vision of risk management is really reliant on the involvement of senior management. The goals of risk management need to be correlated to the goals and missions of the firm. Management need to understand that risk management is not separate from business; rather it is part of business. There is no such thing as credit risk, market risk or operational risk. Instead there is risk which is the real currency of the firm. Its coordinated management as set out in some of the recent inconsistent papers is as important to the business as taking deposits or lending. The maintenance of a reputation within a bank needs activity to be both profitable and to ensure that there are no surprises; that the business can weather a perfect storm better than its peers and meets the expectations of its stakeholders. Do you think risk management is there even now?

With regret the over concentration on models built using data from an interest rate declining environment combined with limited common sense will be part of the problem. The silos remain and risk management is still rarely fully embedded into the first line of defence. It is common sense but that is rarely common.

# What is Risk Appetite?

*Much is written regarding risk appetite yet the subject does not appear to be well understood. In this paper we do not focus on the existing rules or regulations which are generally inconsistent and lack clarity, rather we propose the method of calculating risk appetite that is most suitable. This article is part of a new book which Dennis Cox, Chief Executive at Risk Reward, is currently developing entitled “Risk Management in a Nutshell” which he hopes to finalise in 2016.*

For us a suitable definition of risk appetite is “the level of divergence from goals and missions which is unacceptable to the governing grouping”. This general definition clearly shows that risk appetite is both negative and positive and that it is a top down concept. It enables the governing grouping to develop controls and reporting to enable them to have confidence that the business will achieve its goals and objectives with reasonable certainty.

The purpose of risk appetite modelling is to provide that management grouping with the assurance that they require. It is the currency that creates a consistency of risk management across the entire business covering those risks which are relatively easy to measure and those where this is difficult to achieve.

## How do you calculate risk appetite

Given that we are defining risk appetite as a centrally designed concept it needs to be calculated by using metrics which resonate with the governing committee. These metrics will provide them with guidance as to the level of divergence (risk tolerance) which they may need to accept with reluctance. In these terms impact upon liquidity, profitability, economic value, growth prospects or brand need to be identified which work for the specific firm.

Clearly from this it is clear that no single model could work for all firms. Risk appetite is central to the way that the firm is operating and the metrics need to be designed to meet those expectations. Of course the risk appetite value so calculated will be a single value. In reaching this we tend to identify a series of values which fit each of the proposed metrics and identify the areas where they overlap. This area we refer to as the zone of tolerance within which the risk appetite value will sit. However as mentioned it is an all risk value and consequently a lot more modelling needs to be conducted to make it work for a firm.

## Modelling Risk Appetite

For risk appetite modelling to make any sense it needs to be aligned to the risks that the business runs. In these terms it makes no difference which industry the firm is involved with since the principles are likely to be the same. Since risk appetite is essentially an all risk figure the first stage in the work is to deal with the risk correlations which surely exist between the key risk types within the business. If a typical risk analysis at the highest level is as follows:

- Strategic risk
- Reputational risk
- Credit risk

- Market risk
- Liquidity risk
- Operational risk

then the risk appetite value needs to be applied to each of these areas. Clearly the full risk appetite value could not be applied to any risk alone since were that risk to materialise then were any of the other risks to also occur the level of loss would exceed the group risk appetite which is clearly unacceptable.



## What is Risk Appetite?

Consequently the value of the risk appetites at the primary level for the risks above is likely to add up to perhaps 180% of the risk appetite value. The level is found through analysing what actually occurs and the extent to which multiple risks do tend to occur in reality.

Of course the risk analysis which the firm employs will not need to follow that suggested above. However after the correlation work has been conducted, the next stage will be to cascade the risk appetite down to the level at which risk is actually managed. Too often it is the failure to properly embed risk management within the business that leads to the failure of the concept to make any real difference. So long as you remember that the goal of risk appetite is to ensure that risk is managed consistently throughout the business in accordance with the expectations of the governing committee then you will not go far wrong.

Of course at each stage of the cascade process correlation within the specific risk type will still need to be considered or you do run the risk of over controlling your business. I am not suggesting that any of this is easy and again back testing using actual data held within the firm for things that have gone wrong needs to be applied,

### Reporting Risk Appetite

It would not make sense for all limits and controls to be designed and set at the level of the cascaded risk appetite normally referred to as the unitary risk appetite. This is the risk appetite which applies in a single business unit and is managed within the business. Instead the business tends to apply a tactical risk limit which is a subset of the actual risk appetite. Consequently when the tactical risk limit is exceeded it will not automatically result in a breach of the risk appetite requiring a higher level of reporting and action. The result of this is that much of the risk appetite reporting is directional in nature showing trends leading to action being taken to prevent unacceptable levels of loss.

### The Mistakes People Make

As to why risk appetite gets such a bad press and is so poorly understood and managed, this is actually down to a lack of clarity in the definitions provided by various bodies. They

are inconsistent and often fail with the use test. They cannot be used in practice. A simple value based approach can be easily implemented within the business. They will be given values which they must ensure they do not lose. They will also be concerned if they make unexpected profits since these may not repeat resulting negatively in the growth pattern of the firm.

Too many firms are confusing elements of risk and control self assessment with risk appetite modelling. Risk and control self assessment by its nature is bottom up. It seeks to ensure that management really understand the nature of their control environment and encourages them to seek its improvement. The loss value resulting from the risk and control self assessment clearly cannot exceed the risk appetite but that is the only element of connectivity. They are different concepts with different goals. Accordingly a model developed for a single risk to consider the risk appetite of say operational risk is fundamentally flawed.

When risk appetite was first introduced by the Bank for International Settlements in their draft operational risk sound practices paper they did so without any form of explanation. Approaches were designed by different firms some of which were at best confused and have resulted in some of the confusion which we still see today. As we have mentioned we see risk appetite as a value which can be understood by the firm and all of its employees. They all design their systems such that the level of additional loss or profit would not exceed this value and this provides the governing grouping with the level of assurance that they require.

While to conceptualise is easy its implementation is always fraught. However the gain is worth it in terms of consistent risk management throughout the entire business. It leads to discussions as to the level of staff required to apply controls in an area or the error rates which are acceptable. Moving away from the zero errors culture which appears to apply to some risks (perhaps operational risk) as compared to other risks where significant losses appear to be acceptable (for example credit risk) is part of the goal here. Consistency will reduce controls in some areas and increase them in others adding value to the business and improving its efficiency.



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