SETTING UP A RISK ORGANIZATION

PROCESS INVOLVED SETTING UP RISK MECHANISM

(a) **Bank-wide audit** to identify and rank the critical areas of risk exposure.

- Audit should be across all operations, functions and hierarchies. The **focus** should be on the existence of and **adherence** to various **systems and procedures** to find out inadequate systems and procedures, dual responsibilities of personnel while segregating duties and unchecked transactions
- Under trained or untrained manpower, inadequate organizational arrangements for reporting of routine or exceptional transactions or ignorance of available technology supports or binding regulations could be critical issues thrown open by such audit.
- An audit by an external agency should be more rewarding.

(b) **Assessment of current risk environment and prevalent risk management practices**

- The bank might be taking undue risks during intra-day or overnight transactions.
- The concentration for industry/ group/ currency/ country may be happening unwittingly/ unknowingly.
- The lack of coordination between domestic and international treasury could be resulting in excessive counter party exposures.

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- The risk management practices may be limited to annual inspection or audit.
- There may be absence of policies like stop-loss/ cut-loss.

(c) **To develop benchmarks or standards for each risk-taking activity based upon historical trends**.

- This could warrant revising or modifying the existing standards or even abandoning them in favour of new ones.
- When the bank wants to enhance substantially its earnings from securities trading, an effective mechanism of checks and balances shall have to be put in place.

(d) **Set the standards**, **devising the mechanism for risk identification/ measurement/ monitoring**

Commencing from the lowest level of risk and going into all of them in an ascending order.

Implementation of risk management programme, coordinating various tasks across the functionaries and reporting mechanism should be a part of this step.

(e) The last but the most significant step **is defining the roles and responsibilities** of the board of directors, their committees, executive management, risk management organization and Asset Liability Management committee.

The role description of each of these should also form a part of the documentation.

PRE-REQUISITES

- It must be recognized that the implementation of effective risk management system depends upon a variety of factors, firm commitment from the senior management of the bank.

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- Risk management is **neither a one-time activity nor restricted to a particular cadre**. It cuts across all hierarchical risk management function levels.
- The risk organization involves **development and adoption of appropriate policies and procedures**.
- A **continuous review and updating** of such policies and adoption of procedures is equally significant.
- **Feedback through an audit function** should also form a part of the effort.

When a new function is established, the first issue that needs to be encountered is

- getting the required manpower in adequate quantity and quality.
- Setting up of a multi-disciplinary team for the analysis and monitoring activities is a necessary pre-condition.
- Training the team on various aspects of risk management is important.

Use of dependable technology plays a major role in risk management process.

- The risk organization has **three distinct parts** front, mid and back office.
- These concepts are applicable for the credit and treasury functions.
- Technology solutions are available to address these three requirements without compromising the basic of risk management process.

Data integrity is a condition in which data has not been altered or destroyed in an unauthorized manner.

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- Integrity exists when computerized information is predictably related to its source and has been subjected to only those processes which have been authorized by the appropriate personnel.

Model validation is the process of gaining confidence with a model achieved by "twisting and turning".

- The model to scrutinize all aspects of it and also to ensure that the model captures the risks that are unique a specific bank/ specific environment/ specific geography.
- Of particular importance is the model's ability to reproduce the behaviour of the validation data sets. Thus, it is important to validate models and techniques used in the risk management process.

Documenting the experiences and decisions made in a systematic manner is of significance.

The knowledge of past decisions, the circumstances under which the decision was made in a particular way and above all, the rationale used to arrive at the decision are all important parts of the preparation for putting in place a risk management mechanism for future.

FUNDAMENTALS

- The **entire risk management process is based on the numbers and data** that are generated through accounting records of all transactions.
- Proper accounting policies and procedures and ensure strict adherence thereto.

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- This has to be the case with all products on asset and liability sides of the financial statement, Regulatory and other guidelines on accounting Standards need to be factored in arriving at appropriate accounting policies.
- The **accounting function has to be supplemented** by periodic reviews by different types of audit.

Daily oversight by independent risk management or compliance unit, independent reviews by internal auditors, annual review by external auditors and annual or more frequent review by regulators are the usual processes followed in this regard.

In treasury operations, the basic control is established by segregation of trading to undertake of those who operate and those who record the performance is the first managerial step in the risk management process. Similarly, the person doing reconciliation work, should not have any authority to pass or validate accounting ticket voucher .

While assessing the risk profile, one of the task is the verification of yield curves, exchange rate etc., that are obtained from external sources by the bank.

- These sources need to be consistent, independent and unrelated to the bank concerned.
- Verification of revaluation rates and yield cures used for risk management and accounting purposes, therefore, is of significance.

The entire risk management process is based on the assumption of availability of manpower, technology and organizational supports.

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Documenting and periodically testing Disaster Recovery Plan and back up procedures involving front and back offices as off-site facilities are also the key requirements of the risk management mechanism. **Documentation of the testing exercise** is also important from the regulatory perspective.

One of the issues in the risk management process is related to human resources. This aspect significant for treasury operations as the number of people manning treasury are far less than people
provided to manage similar volumes of banking work. This calls for sufficient human resources and
system supports to ensure that deal processing and risk reporting remain timely and accurate.

Development and adoption of new products would be another issue.

- The **new product approval and implementation procedures** have to be scanned/ verified in 360 degrees.
- It must include **authentication** by legal, audit, systems, operations, risk management and accounting departments.
- **Vetting** by all these units has to precede the product introduction even on pilot basis.

OPERATING MANUALS

- The regulators insist on **availability of well documented** and appropriately approved operating manuals for risk management.
- It is necessary that the operating manuals and the technological supports are interwoven to get best out of both.

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- The organizational recording of this type is useful for users, regulators, auditors, besides ensuring the uniformity of processes across the bank and across various people.

CONCENTRATION RISK

- It can be in terms of a product, line of business, geography, borrowing party or group, commodity or currency.
- Banks to set out its own prudential limits
- These are to be documented and made available to all concerned as this is the core of risk management.
- There are certain regulatory prescriptions in some countries on exposure limits
- These are also to be complied with while fixing the ceiling.

MISCONCEPTIONS

There are primarily four myths about risk management.

Myth I: Risk is Bad

Some of the risk can be measured, it will help the bank to make more informed decisions.

Broader view is that the risk prevails in the financial markets. Such a contradiction could confuse those who study the discipline.

Also **a restricted view could vitiate the responses** to risk situations.

In the process, the ever-increasing ability to measure risk becomes the casualty.

Risk is a balancing act in which the bankers balance the expected rewards of their actions against the perceived costs of failure, Risk always involves/ looks for a potential reward, whether real or imagined, tangible or intangible.

It also has a cost. It is for this reason why bankers make decisions involving risk.
Risk management framework thus becomes a discipline for dealing with uncertainty, an acknowledgment that both risk and uncertainty are creative stimulants in all walks of life and are all pervasive.
Bankers should therefore relish, not avoid it; balance, not eliminate it.

Myth 2: The Goal is to Benefit Shareholders

- **One should not become short-sighted**, losing touch with the longer-term principles that support survival.
- If the focus is narrow "shareholder value", how does one apply risk management to non-profits, mutual companies or governmental organizations?
- Risk management's most important role is becoming the mechanism that corrects erratic steering, bringing the vessel back on a principled course.
- The proper course is to serve all stakeholders, from employees and customers, to suppliers, investors, lenders, regulators, and the community at large.
- Risk management, like general management, must serve all stakeholders, not just shareholders.

Myth 3: Risk Management is the Responsibility of Specialists

- Over the years, numerous pillars of risk management specialization have been erected on the assumption that each specialty is derived from long experience and the classification is exclusive.
- The recent move to strategic, integrated, enterprise, or holistic risk management is recognition that the separation of risk function is not effective.

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- That is one reason why there is a need for new exclusive Chief Risk Officer (CRO). This person reports to both the Chief Executive and the Board and coordinates the work of other risk specialists.
- The assumption that risk management is no longer the sole province of specialists. It is now the responsibility of each and every person in the organization.
- The aim now is to build a culture of risk understanding so that informed decisions may be made at every level and every day.

Myth 4: Risk Can be Transferred

- There is **no such thing as risk transfer**, there is only risk sharing.
- **Some risk may be shared**. An entrepreneur shares both reward and loss with investors who buy stock.
- **Some risk may be diversified**. A trader sells a derivative. An insurance buyer shares risk with an insurance company, a pooling of funds given to a fiduciary in return for dispensing them under certain circumstances with certain conditions.
- **Yet most of the risk remains with the original decision maker**, and the sharing actually creates a new risk, that the counter party may be unable to meet its obligations.
- **Another misconception is that insurance actually solves a risk problem**. It does not. It simply provides the possibility of some sharing, some spreading of the risk.

COMPREHENSIVE VIEW ON RISK

The risk organization of a bank is expected to respond to three basic questions to be effective:

1. **What risks will the bank not accept?** (e.g. environmental or quality compromises)

2. **What risks will the organization take on new initiatives?** (e.g. new product lines)
3. **What risks will the organization accept for competing objectives?** (e.g. gross profit vs. market share? Increasing profit or aligning more towards social needs)

The replies will help determine the risk appetite the bank has and is capable of taking.

Risk organization does not work in isolation. It requires coordination amongst practically all functionaries particularly finance, security, insurance, audit, human resources, operations, compliance and legal departments.

The **appetite decides four options for managing the risks**. These are: accept, avoid, reduce or share.
The methods used to handle these options are: monitor, eliminate (get out of the situation), institute control or share (partner with someone) respectively.

RISK ORGANIZATION

The risk management organization delineates the tasks at three levels:
1. Board of Directors
2. Executive Management
3. Operating management

Also, there are specific duties detailed for **audit functionaries** from within the bank or outside.

Board of Directors

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- It is the **supreme decision-making body**. It decides the course of action the bank should follow.
- It provides the required leadership and facilitates the goal setting.
- **Primary task** of the board is setting a common direction and goal and development of the required capability for the bank.
- **Each bank will have a unique business profile** in terms of its composition, strengths and weaknesses, the market to be served and business focus. Based on such basic information, the board makes a decision about the level of risk which should be acceptable.
- A blend of optimal return and minimum risk is required to be worked out for this purpose.
- An atmosphere conducive to risk management is to be created by actions and explicit policies by the board of directors.

- The board does not have, rather should not have, day to day responsibility but the task it undertakes leads the entire way to risk management.
- The decision making of board is critical as the impact of error would most adversely affect the bank.

For assuming the responsibility, with inputs from senior management, the Board would take up the following steps:

- **Monitor the risk situation** of the bank systematically to identify and evaluate the sources of risks.
- **Understand and influence the management appetite** towards risk.
- Take a total assets view of the exposures.
- **Assess the significant risks** that are more pronounced.
- **Evaluate the methods used for risk assessment** as also the organizational structure proposed for the function.
- Encourage the consultative decision-making process.

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Executive Management

- The **basic work for facilitating the board** to make decisions is done by the executive management.
- The **concentration of exposure** in terms of geographies, parties, commodities and currencies etc has to be monitored by determining the limits for these aspects.
- The **approval of these limits** is the basic risk management activity and decision on the approval of such ceilings is taken by senior management.
- **In respect of policies and procedures**, senior management has two tasks to perform.
- Ensuring that policies and procedures for conducting business activities on both long, short term and day to day management basis are adequate and up to date. Developing and monitoring these aspects is the responsibility of senior management.
- The **board needs regular inputs** for facilitating decision making Board also requires information on risk management issues on a regular basis.
- This could be in the form of periodical information reports including the prescriptions given by the regulators besides internally developed parameters.
- The senior management is **responsible for drafting of the long** and **short-range plans for the bank** with the changing business contours and the emphasis being placed on risk management issues.
- The **reporting system** is to be put in place for both, periodical and exception reporting.
- The formats, frequency, the recipients thereof have to be detailed.

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- It would entail the reporting of approvals, escalation mechanism for exceptions and excesses over discretion and procedures for recording these exceptions. This task is again for the senior management to undertake.

OPERATING MANAGEMENT

The operating management includes **people who actually do business or those who take risks as a routine**. The various aspects the operating management needs to address include the following:

- **Operating within relevant levels** of authority, prescribed ceilings and laid down procedures while committing the bank to various transactions.
- **Obtaining adequate information** about the customer, counterparty before entering into transaction.
- **Gathering sufficient details of market situation** to make decisions on pricing.
- **Considering the counter party's expertise** in undertaking transactions with comparable complexity.
- **Assessing funding requirements** and making necessary arrangements to raise funds.
- Ensuring that **complete accurate and timely controls** are in place.
- **Adhering strictly to approved policies** on mid-market rates, bid-offer rates and the like.
- **Preparing income statement** on a daily basis.
- Following **independent review procedures** for prices and rates.
- **Obtaining confirmations of all trades** on the same day basis.
- **Seeking authorization of senior staff** to all cash and security movements and ensuring separation of trading processing and reconciliation activities.

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- **Ensuring reconcilement** of internal and counterparty accounts on a regular basis.
- **Ensuring controls to see that bank's assets** are safeguarded and customer assets are identified and segregated.

INTERNAL AUDIT FUNCTIONARIES

While the board, executive and operating managements are engaged in developing the risk management organization and policies and procedures and following them, **the internal audit function looks into the monitoring aspect with a dispassionate outlook**.

This includes **primarily the review of critical control systems** and risk management processes.

Matters relating to operational risk will also be addressed by having internal control mechanism in place.

Internal audit function **undertakes an effectiveness review of risk assessments and the internal controls** which provides valuable feedback to improve the assessment processes as well as internal control.

Hedging or other risk mitigation strategies are developed as part of this exercise. Internal auditors review these systems as well as the risk mitigation strategies.

As the outcome of such review, providing advice in the design and improvement of control systems and risk mitigation strategies becomes the responsibility of the auditors.

Imbibing the concept of risk in the long and short-term planning exercises is the task of the senior management.

Such planning exercise can be subjected to a review and audit by the internal auditors.

There may be a **tendency amongst banks** to audit those areas that are less risky and safe to get audited, in the hope of a clean audit report that hides more than it discloses. In the process, the critical areas

remain neglected as they are not subjected to a rigorous audit. Ensuring that internal auditing resources are directed at areas most important to the organization should become a priority.

ENTERPRISE WIDE RISK MANAGEMENT

- Enterprise wide Risk Management (ERM) is a concept that has been adopted by insurance companies and evolving in banks.
- All activities, all functions and all hierarchies are covered by the ERM concept. Such an effort requires huge training across any organization like a bank.
- In this regard an important task for auditors is defining risk tolerances where none have been identified.
- The experience, judgment of the auditor and consultation with management should pave way for defining such tolerances.

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