ACAE CHARTERED ACCOUNTANTS CPE STUDY CIRCLE OF EIRC OF ICAI

NBFC CONCLAVE:

AUDIT, ASSURANCE & RISK: BUILDING TRUST

Risk Governance in Financial Institutions

Scope…

- Risk Management Functions
- Risk Management Framework
- Key Responsibilities
- Risk Governance Framework
- Risk Culture
- Risk Communication
- Supervisory Expectations

Objectives

- Why must banks adopt sound risk management practices?
- Who is responsible for effective risk management?
- What is risk culture?
- How to improve the risk culture in FIs?
- Supervisory Assessing Risk Management

Risk Management Functions

- **Risk Management-** **The process of establishing controls in order to *identify, measure, monitor and mitigate the risks.***
- **Four pillars of Risk Management**
  - Board and Senior Management Oversight
  - Policies and Procedures
  - Identification, Measurement, Monitoring, mitigation and Communication
  - Compliance, Internal Controls and Audit
- **The approach to risk management may in FIs depend on a range of factors, including size and sophistication, nature and complexity of its activities.**

Risk Management Functions

- **Risk Management-** A key element of a sound governance structure is an effective risk management function. To make Risk Management Function effective:
  - It needs sufficient stature (authority) within the bank
  - It should be independent from other risk-taking functions and not involved in revenue generation
  - It should be staffed with appropriate resources to effectively challenge business operations regarding all aspects of risk
  - Needs direct access to the board, which allows it to report and – if necessary – escalate important risk issues

Risk Management Framework

- **Key elements of Risk Management Framework:**
  - **An effective risk appetite framework,**
  - **An effective risk appetite statement,**
  - **Risk limits,**
  - **Responsibilities of the board and senior management**
- The Risk Management function forms part of the bank's second line of defence and is responsible for overseeing risk-taking activities (risk exposures) across the bank.

Risk Management Framework

Risk Appetite Framework (RAF):

- The overall approach, including policies, processes, controls, and systems through which risk appetite is established, communicated, and monitored.
- RAF includes a risk appetite statement, risk limits, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF.
- An appropriate RAF should enable risk capacity, risk appetite, risk limits, and risk profile to be considered for business lines of the bank
- The elements of the RAF should be applied at the business lines in a manner that is proportionate to the size of the exposures, complexity and materiality of the risks.
- The RAF should be aligned with the business plan, strategy development, capital planning and compensation schemes of the bank

Risk Management Framework

Risk Appetite Statement (RAS):

- The articulation in written form of the aggregate level and types of risk that a financial institution is willing to accept, or to avoid, in order to achieve its business objectives.
- RAS includes qualitative statements as well as quantitative measures expressed relative to earnings, capital, risk measures, liquidity and other relevant measures as appropriate.
- RAS should be easy to communicate and therefore easy for all stakeholders to understand.
- RAS should be directly linked to the bank's strategy, address the material risks under both normal and stressed market and macroeconomic conditions, and set clear boundaries and expectations by establishing quantitative limits and qualitative statements.

Key Responsibilities

- **Key Responsibilities-Board and Senior Management**

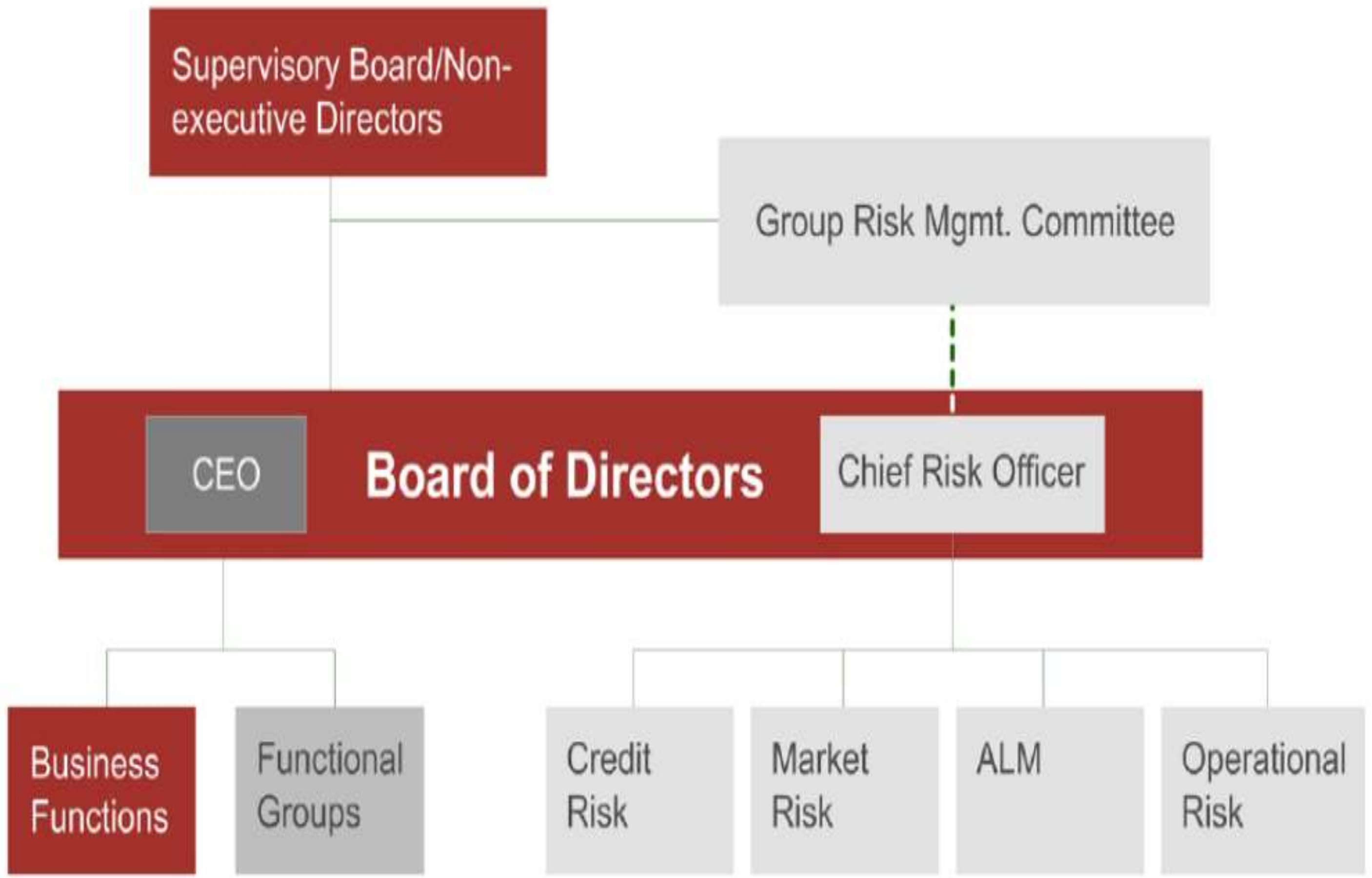
- Developing and implementing the enterprise-wide risk governance framework
- Board may establish the institution-wide RAF and approve the RAS
- The RAS is developed in collaboration with the senior management (CEO, CRO & CFO).
- Identifying, assessing and monitoring of risk-taking activities and risk exposures
- Senior management accountability for timely identification, management and escalation of breaches in risk limits.
- Internal Controls commensurate with the risk profile, including an independent audit
- Establishing an early warning system for breaches of risk limits
- Reporting risk-related issues to senior management
- Ensure adequate resources and expertise are dedicated to risk management/internal audit function
- Risk management should be supported by robust IT and MIS for risk monitoring & Mitigation

Key Responsibilities

- Key Responsibilities-Board and Senior Management
- Enterprise-wide risk governance framework
  - Risk culture
  - Risk Appetite
  - Risk limits
- Components of the risk identification and monitoring process:
  - Risk Identification and Coverage
  - Risk Measurement
  - Data Integrity
  - Infrastructure
  - New Products and Services
- The above processes requires particular attention from banks and banking supervisors.

Key Responsibilities: CRO

- **CRO has overall responsibility for overseeing the development and implementation of the bank's risk management function, which includes:**
- Strengthening of staff skills
- Enhancements to risk management systems and policies
- Supporting the board in its development and oversight of the bank's risk appetite and RAS
- Actively monitoring performance relative to risk-taking
- Participating in key decision-making processes



Key Responsibilities: CRO

- The CRO should have the necessary stature, authority and skills to oversee the bank's risk management activities.
- The CRO must also be independent, and this requires him/her to:
  - Have access to all necessary information
  - Be excluded from revenue-generating functions
  - Not be 'dual hatting' (COO or CFO should not play the role of the CRO at the same time)
  - Report and have direct access to the board or its risk committee
  - Regularly interact with the board and management on key risk issues

Governance Risk-RMC

- ***Risk Management Committee in NBFCs***

- Every NBFC to have an RMC.
- Either at Board or Executive level.
- Responsible for evaluating the overall risks including liquidity risk.
- H/Y Reviews of Material Outsourcing.
- Shall report to the Board on various risks.

Governance Risk . . . CRO

Chief Risk Officer (CRO)

- **Objective:** To strengthen **independent risk management** in systemically important NBFCs.
- CRO a senior officer.
- Adequate professional qualification/ experience in the area of risk mgmt.
- Fixed tenure with Board approval.
- Transfer/removal before tenure only with Board approval.
- Direct reporting to MD/ RMC of Board;

- **Roles & Responsibilities:**
- Oversee risk identification, measurement, and mitigation.
- Shall vet all credit products for inherent/control risks.
- Act as an advisor in credit proposals.
- No dual hatting
- ICAAP process
- Risk Appetite

Board and Senior Management Oversight

- **Responsibilities of the Board and Senior Management:** The board of directors is ultimately responsible for the operations and financial soundness of the bank.
- The board executes its responsibilities in a range of key areas:
  - **Strategic Responsibilities**
  - **Risk Appetite Responsibilities**
  - **Key Policy Responsibilities**
  - **Financial Responsibilities**

Board and Senior Management Oversight

- **Strategic Responsibilities:**
  - Oversee the development of business objectives and strategy and monitor their implementation
  - Oversee implementation of the governance framework and periodically review
  - Oversee the performance of the key members of senior management and control functions
  - Fostering timely and adequate interaction between Board and Senior Management
  - Ensuring adequate involvement of the Board level Committees in key strategic decisions
- **Risk Appetite Responsibilities:**
  - Establishing the level of risk commensurate to the size of the bank
  - Monitor and approve the changes in risk exposure limits and risk profiles
  - Oversee the adherence to the risk appetite statement, risk policy and risk limits
  - Play a lead role in establishing the bank's corporate culture and values

Risk Governance

- A bank has a strong risk governance framework when it operates within clearly established limits, takes appropriate actions if these limits are breached and notifies the board in case of excessive risk-taking.
- Risk governance applies the principles of good governance to the identification, measurement, monitoring, management and communication of risks.
- Clear strategies and oversight by the Board and senior management; a strong risk culture, internal control culture; effective internal reporting; and contingency planning are all crucial elements of an effective risk governance framework.
- The risk appetite of a bank is a critical element of the risk governance framework and would establish the tolerance limits for the bank.

Risk Governance

- The board is responsible for developing, overseeing and conveying a robust risk governance framework that includes:
  - **a strong risk culture**
  - **a well-developed risk appetite articulated through the RAS**
  - **well-defined responsibilities for risk management and control functions**
- **The RAS has following features:**
  - **Aligned** with bank's strategy, capital and financial plans and remuneration practices
  - Developed by both top-down board leadership and bottom-up management involvement
  - Includes quantitative and qualitative considerations
  - Has clear mandates and responsibilities for the **three lines of defence,**
  - Is communicated effectively throughout the bank
  - The RAS should be subject to periodic review
  - The RAS has a **feedback mechanism** to raise risk issues and concerns.

Risk Culture

- Risk culture relates to the norms of ***behaviour*** for individuals and groups within an organisation that determine the collective ability to identify and understand, discuss and act on the organisation's current and future risk.
- Risk culture influences the decisions of management and employees during the day-to-day activities and has an impact on the risks they assume.
- A sound risk culture bolsters effective risk management, promotes sound risk-taking, and ensures that emerging risks are recognised, assessed and immediately escalated.
- To understand the risk culture, we must have a broad understanding of expectations from the risk governance framework.
- Risk culture is an integral part of risk governance as it shapes risk decisions of the management

Risk Culture

- **Essential elements of a sound risk culture:**

- **Tone from the top:** The Board and senior management are the starting point for setting the bank’s core values and expectations for the culture of the institution, and their behaviour must reflect the values being advocated.
- **Responsibility**: People are generally motivated to think in a critical manner when the overall environment promotes responsible decision making within the entity.
- **Effective communication and challenge:** A sound risk culture promotes an environment of open communication, encourages a range of views, allows for testing of current practices, stimulates a critical and positive attitude among employees, and promotes an environment of open and constructive engagement.
- **Incentives:** Performance and talent management encourage and reinforce maintenance of the entity’s desired risk management behaviour.
- **Ex Ante and Forward Looking:** The focus here should be preventive. Sound risk culture encourages assessment of the activities of the entity ex ante, forward looking and prevent excessive risk taking.

Risk Communication

- **Risk Communication:** An effective risk governance framework requires robust communication within the bank.
- Senior management should actively communicate and consult with the control functions on management's major plans and activities so that the control functions can effectively discharge their responsibilities.
- Characteristics of good risk communication:
  - **What has to be communicated and for what purpose**
  - **To whom should information be communicated**
  - **How should information be communicated**

Supervisory Expectations

- Supervisors may interact regularly with board, senior management and discuss:
  - Bank's strategies, business model and risks
  - The effectiveness of corporate governance
  - Bank’s risk-culture
  - Management issues and succession planning
  - Compensation and incentives
  - Supervisory findings

Supervisory Expectations

- Supervisors play an important role in fostering sound corporate governance:
  - Providing guidance on expectations for sound corporate governance
  - Comprehensively evaluating governance practices
  - Maintaining regular interaction with boards and senior management
  - Requiring improvement and remedial action as necessary
  - Cooperating and sharing relevant information with other supervisors

Conclusion

- Risk management is not a one-time task but a continuous process
- Institutions that manage risk well are more resilient, competitive, and trusted
- An adequate and effective risk governance framework helps build resilient organisations that enjoy sustained growth and customer confidence
- A sound risk culture bolsters effective risk management, promotes sound risk-taking, and ensures emerging risks are recognised, assessed & managed.
- Supervisors have a keen interest in sound corporate governance, as it is an essential element in the safe and sound functioning of an institution.

Thank You

Questions ?

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