



# *The Professional Risk Managers' International Association*

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# Developments in Risk Governance

- Some words on the current crisis
- Drivers for good governance
- Recent market views
- PRMIA's Risk Governance Guidelines
- Can Confucius help?

# Drivers for the financial crisis?

- Change in the borrowing/lending, and the bank revenue models
- Easy credit, poor lending strategies and securitisation
- The failure of risk governance in financial institutions:
  - Profit and bonus driven institutions
  - short-term profit was the only goal
  - and all believed there was no downside

# The models changed

<u>Old model</u>	<u>Crisis model</u>
Retail/ commercial banks split from investment banks.	All banks borrowed, lend and make proprietary investments.
Banks take deposits and lend them to borrowers.	Money was borrowed on the inter-bank market to lend.
Bankers were service focussed and rewarded. Salary, benefits and pension were the main rewards.	Bankers were sales focussed and rewarded. Bonus was the main reward.
Secure growth was the objective.	Immediate profit and share growth was the target.
Jobs were long term which encouraged secure investing	Bankers encouraged to go for high risk strategies – with no downside.
Banks were small and could fail.	Banks were big and global and would not be allowed to fail.
Regulators “soft touch” word (and guidance) was obeyed.	Regulators needed to be prescriptive and rulings were open to legal interpretation.

# The result .....

- A financial system based on inter-bank liquidity and not on deposits
- An investment environment where it was easier to borrow than to save
- A culture where risk taking was rewarded with no penalty for failure
- Economies where governments encouraged the borrowing and regulators were not in control.
- A risk governance and management framework that was sufficient – or was not implemented.

Are things improving?

# But there are beneficial drivers for good governance

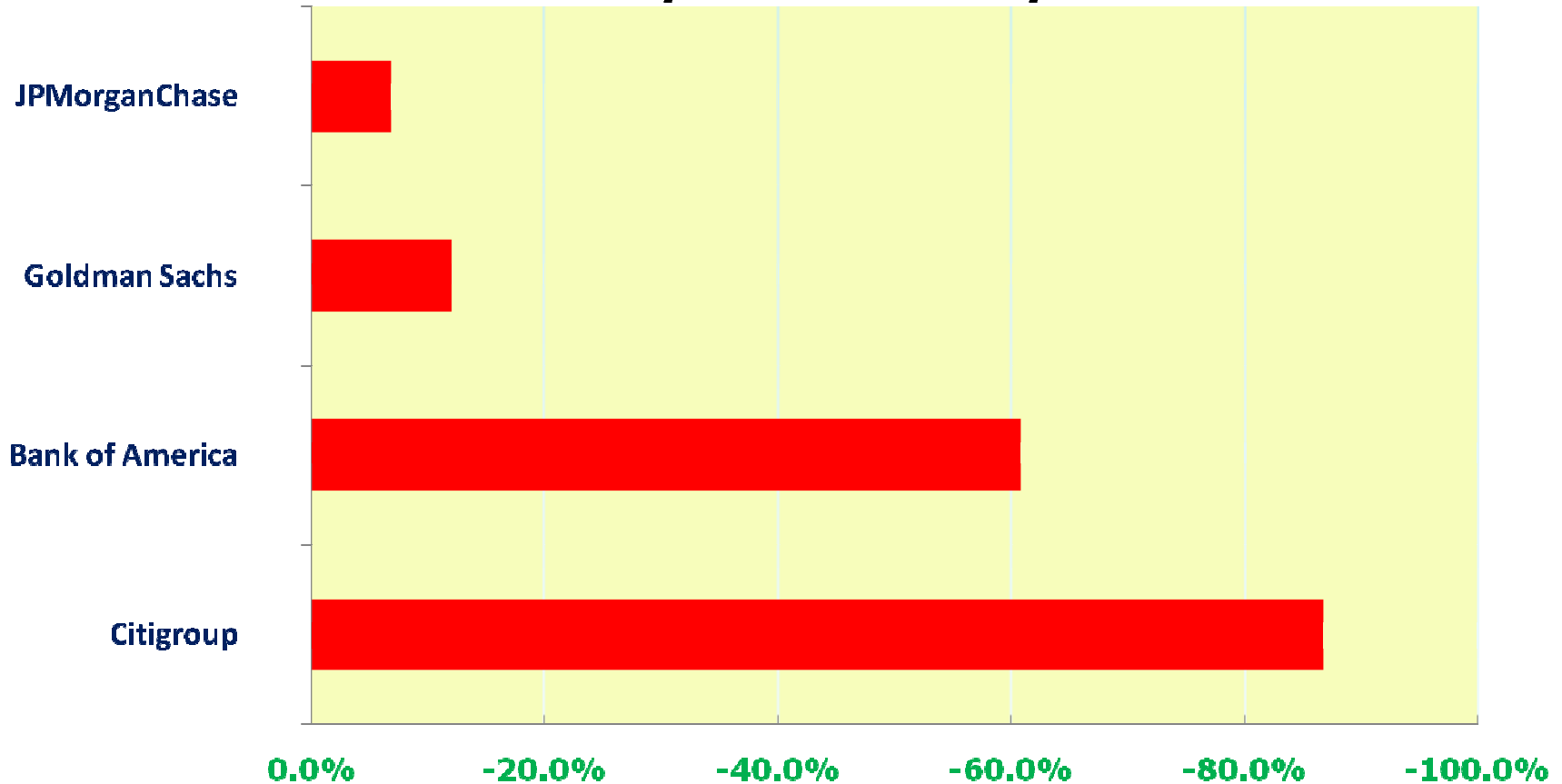
- **Improved share price** (*“Corporate Governance and Equity Prices”; Gompers, Ishii and Metrick, Wharton, 2002. Also “Corporate Governance, CEO Compensation and Firm Performance”; Holthausen and Larcker, Journal of Financial Economics, 1999*)
- **Improved cash flow** (*“Corporate Governance and the Value of Cash Holdings”; Dittmar, U of Michigan, and Mahrt-Smith, U of Toronto, 2005*)
- **Improved ratings** – *all the major rating agency use corporate governance in rating organisations - see next page for an example*
- **Investors are using corporate governance ratings** – *“The Governance Fund, LLC, is a private investment management firm that seeks to capture hidden value by differentiating well-governed companies from those which are poorly governed. The firm utilizes guiding metrics centered on effective corporate governance in seeking to realize undiscovered returns and extract greater gains from publicly traded companies.”*

# From Fitch Ratings

- Credit analysis rating
  - Quality of risk management, board independence and effectiveness, management compensation
  - Compare quality of governance with other companies
  - Evaluate transparency
  - Review to reflect qualitative attributes
- “Corporate governance practices are critical to how a company manages assets and controls risks. Fitch looks for:
  - Strong practices to promote culture of risk transparency
  - Top-down governance
  - Risk managers and business lines communicate risks up the chain of authority

# Governance and Share Price

**Major US Banks' Share Price Change  
23 July 2008 - 23 July 2009**



# Recent market views

*“Deficient corporate governance and risk management systems were critical factors leading to the current financial crisis and in differentiating the performance of firms during the crisis”* Damon C Morris, Director of Policy Studies at the eStandards Forum

*“Looking ahead, firms need to address gaps in risk governance that cut across these problems <fixing risk governance> as a matter of priority. Three key fixes include: Establishing a firm-wide risk committee, developing a strategic risk assessment capability, integrating risk with business strategy and compensation”* Andrew Kuritzkes, Oliver Wyman

*“Two key pillars are emerging as supporting components of enterprise risk management: risk culture and governance, and risk-based-decision making”* Towers Perrin brochure material.

# The UK Walker Review

This review of corporate governance in UK financial firms (July 2009) made 39 recommendations on corporate governance, including:

- The board should establish a board risk committee separately from the audit committee.
- In support of board-level risk governance, a board should be served by a Chief Risk Officer.
- The board risk committee should have access to and, in the normal course, expect to draw on external and competing experiences in its role.
- The board risk committee should carry out due diligence of a proposed acquisition or disposal.
- The board risk committee risk report should be included as a separate section within the annual report and accounts.

# PRMIA's response to governance questions

- PRMIA Principles of Good Governance first created in 2006
- Revised in May – July 2009 and will be issued to members October 1<sup>st</sup> 2009.
- PRMIA Review Committee of academics, risk managers, regulators and board members.
- Based on 10 principles - including experience from commercial and non-commercial entities as well as the expertise of the committee
- Designed to help organisations maximise risk-adjusted return on capital (RAROC), and to transfer the unmanageable and unmeasurable into managed risk

# Principles of Good Governance 1-5

- **Key Competencies** - Adequate levels of knowledge, skills and expertise available to perform - gained through professional qualification or by experience in role.
- **Resources and Processes** - Adequate levels of resource available to operate effectively. The business and technological processes shall be fit for purpose.
- **Ongoing Education and Development** - All employees to understand developments in their areas of expertise with adequate resources provided to enable this to occur.
- **Compensation Architecture** – Employees remunerated adequately for their roles in a framework consistent with the type of risk-taking behaviour expected of the employee.
- **Independence of Key Parties** - key checks and balances in place to assure effective governance and functions such as Audit and Risk Management to be independent.

# Principles of Good Governance 6-10

- **Risk Appetite** - The Board to determine, and record, its appetite for each category of risk within the risk framework – this to be measurable and understandable at all levels.
- **External Validation** - The governance framework to be periodically validated by independent and external bodies to ensure that they are appropriate and consistent.
- **Clear Accountability** - Accountabilities should be clearly defined at all levels. Individuals to know their accountabilities and the consequences of not fulfilling them.
- **Disclosure and Transparency** - The Board and senior management to be consistent and transparent in disclosure and that this approach is consistent in the organization.
- **Trust, honest and fairness of key people** - key people involved in the application of governance and risk management to be trustworthy and honest and treat others fairly at all times.

# ... and finally, Confucius on Risk Governance

Confucius	Risk Governance
Let your evinced desires be for what is good, and the people will be good.	The board of directors and senior management are responsible for promoting high ethical and integrity standards



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