Enhancing Risk Management and Governance in the Region's Banking System to Implement Basel II and to Meet Contemporary Risks and Challenges Arising from the Global Banking System

Training Program ~ 8 – 12 December 2008
SHANGHAI, CHINA

Session 7.2

Challenges to Governance Structures Caused by International Financial System Turbulence – Australian Banking Responses

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The experience of the past 12 months has been a significant challenge to banks' governance structures.

An important early analysis of these challenges and the identification of the characteristics of banks that have been more successful than others in addressing them is the Report of the Senior Supervisors Group presented to the Financial Stability Forum in March 2008. Amongst it conclusions the Report refers to firms that "demonstrated a comprehensive approach to viewing firm-wide exposures and risk, sharing quantitative and qualitative information more effectively across the firm and engaging in more effective dialogue across the management team".

The Report goes on to list defining characteristics of successful firms as including:

- being more adaptive rather than static risk measurement processes and systems and displaying a willingness to consider a range of risk indicators
- a greater willingness to challenge and alter underlying risk management assumptions to reflect current circumstances including with respect to the effectiveness of risk transfer and risk mitigation
- more use of scenario analysis and more effective stress testing to reconsider potential risk outcomes

These factors reflect issues of organisational culture and the effectiveness of senior management engagement and oversight.

It is for this reasons that the opening slide to my presentation starts with the foreign currency option losses that impacted NAB in 2004. The report prepared by APRA (the Australian Prudential Regulation Authority) described "cultural issues" as being at the centre of the risk management failings and losses that occurred at the time.

As a consequence of its findings, APRA imposed a series of requirements on the NAB Board with the objective of ensuring established structures worked effectively in achieving risk management outcomes consistent with sound and prudent management.

The composition of the NAB Board is now based on the following factors:

- the Board will be of a size to assist in efficient decision-making
- the Chairman of the Board should be an independent non-executive director
- the Chairman of the Board must not be a former executive officer of the Group
- the Board should comprise a majority of independent non-executive directors
- the Board should comprise directors with a broad range of expertise, skills and experience from a diverse range of backgrounds including sufficient skills and experience appropriate to the group's business.

These factors are consistent with APRA's prudential standard APS 510 *Governance* and the Australian Stock Exchange's Corporate Governance Principles.

The bank's risk management model in the business was reviewed with the introduction of the "three lines of defence" framework. This emphasises the responsibility and accountability of the business for risk management outcomes and the manner in which the effectiveness of the accompanying risk management structures was enhanced, in particular, the evolution of the role of the company secretary into a chief governance office. The Group's senior management risk committee governance structure and functionality was also re-designed, strengthened and centralised under the same office.

The APRA report also drew attention to an issue of now increasing focus – the appropriateness of remuneration structures for achieving a balance between short-run and longer-run performance with sound risk practice and outcomes. A recent example of these same issues can be found in the 13 October 2008 Letter to CEOs entitled *Remuneration Policies* from the Financial Services Authority of the UK.

The present difficulties in financial markets are raising numerous issues around the effectiveness of governance and risk oversight. Again there are few suggestions that organisational structures have been established in a flawed fashion. What is of concern is that committee structures can allow, if unchecked, an emergence of "organisational silos" with insufficient attention being made to ensuring that what is established is an integrated risk management view of business activities that is sufficiently forward looking.

Yet it is fair to say that the supervisory review principles of Pillar 2 of Basel II have been written with the aim of building such checks particularly those principles dealing with sound capital assessment and the comprehensive assessment of risks. These are further supported by the regulatory expectations surrounding the internal capital adequacy assessment processes of banks, including with respect to the use of economic capital calculations as part of business and strategic decision making.

For NAB these past 12 months has caused it to significantly review and reset risk management priorities. This includes the following:

- Review key risk policies including limit structures and incorporation of responsive and identified escalation processes
- "Cross-silo" meetings of both board and management risk committees including agreement on the establishment of a liquidity risk sub-committee to assist the group asset and liability committee.
- The establishment of this committee has led to the development of new forward looking risk targets, and liquidity and capital management strategies particularly with respect to funding including concentration limits.
- Priorities of committee and board meetings – key issues have been re-prioritised with less focus on business as usual matters.
- Greater frequency of meetings where appropriate – including the updating of information at intervals more frequent than scheduled meetings
- Ensuring the Principal Board is provided with information and market updates by key senior Group personnel (i.e. Group Treasury, Head of Institutional Banking divisions etc) as appropriate and according to market conditions
- Holding of additional meetings between the Chair of the Board risk committee, and the Chairs of all subsidiary board risk committees to share information on challenges and issues in each region
- Ensuring any higher risk business areas throughout the Group are priority reviewed and their strategies revisited

The consequence has been a review and close monitoring of capital and funding requirements and the bank's risk appetite position. This has resulted in deliberately increasing holdings of liquid assets and higher capital adequacy ratios after taking into account the potential cyclicality of risk outcomes.

MAFC / APEC / AFDC Shanghai Conference: Session 7.2: Challenges to Governance Structures

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Key points to be covered

- Governance –The FX Currency Options Loss (2004):
- Regulatory Changes in Governance Expectations
  - established regulatory expectations
  - emergent regulatory requirements
- Risk Committee Structure at NAB
- NAB Risk Management Model in the Business - The Three Lines of Defence
- Significant NAB Governance Changes

Governance –The FX Currency Options Loss (2004):

Subject of special APRA report.

"Cultural Issues" viewed as a central cause. Board to state standards of behaviour, professionalism and openness it expects of the organisation.

Requirements imposed on the Board included:

- Establish effective escalation channels to enable Board / Committees to consider serious risk issues
- Review own composition and structure. Possession of necessary expertise to discharge its duties in relation to risk management
- Review charters of executive risk committees to ensure roles are carried out as described.
- Incentive arrangements to promote behaviours with appropriate regard for risk

Many of these issues are re-appearing in commentaries about current market issues.

Regulatory Changes in Governance Expectations:

- **Established Regulatory Expectations-**
  - APS 510 "Governance" and ASX "Corporate Governance Principles":

    The Board is ultimately responsible for sound and prudent management of the ADI.

    Board capabilities include issues of its composition (independence), skills and experience, effectiveness/size , renewal and accountability.

    Minimum Board Committee requirements – must be a Board Audit Committee.

    External auditor independence including constraints on subsequent employment with bank.

Regulatory Changes in Governance Expectations (cont):

- **<u>Emergent Regulatory Requirements-</u>**
  - The Basel II Prudential Standards:
    - Pillar 1 requires Board and management knowledge of and approval of processes, model design and operation.
    - Board and management responsible for ensuring the establishment of effective systems to measure and monitor risks. Limit risks to prudent levels.
    - Pillar 2 requires all material risks to be addressed by a bank's capital adequacy assessment process
    - Pillar 3 – establishment of Board approved formal disclosure policy: where approval covers issues of disclosure appropriateness, validation and frequency.
  - Recent addition are issues of remuneration policies eg The FSA's recent letter to CEOs

Risk Committee Structure at NAB

- Principal Board – PB Risk Committee and PB Audit Committee.

  Principal Board establishes formal risk appetite statement for the Group.

  Approves all material risk policies, monitors and reviews adequacy of the risk governance framework

- Group Risk Management Committee (chaired by CEO).

  Principal body for risk strategy and risk policy decision making.

- Executive Risk Committees (reflect Basel II classifications) for:

  Capital
  Operational Risk and Compliance
  Market Risk
  Asset and Liability Management
  Credit Risk

- Role of company secretary includes that of a chief governance office for committee structure

NAB Risk Management Model in the Business – The Three Lines of Defence

- Key Principle: Risk management capability embedded in front line teams for effectiveness -
  - **First Line: The business:**

    All business decisions pro-actively consider risk and are accountable for its effectiveness

    Employees are responsible for risk-management in their day-to-day activities and is a core competency
  - **Second Line: Risk Management:**

    Develop and implement policies, processes and tools

    Accountable for independent monitoring, oversight and reporting of risk issues
  - **Third Line: Internal Audit:**

    Reviews effectiveness of risk management practices and confirms level of compliance

    Reports to PB Audit Committee

Significant NAB Governance Changes During 2008

- **Priorities** - PBRC and PBAC joint meeting to review emergent market issues. BAU processes considered inappropriate / insufficient for market conditions and emergent risk management issues - review of policies:

  single large exposures
  risk concentrations
  limit structures
  delegated credit authorities
  product usage authorities
  stress testing

- **Organisational** - Establishment of liquidity sub-committee of GALCO:

  Limits: Liquidity and funding limits revised, new forward looking targets, risk escalation triggers reformed.

  Meetings: Weekly / monthly depending on market circumstances

  Seniority: Chaired by Chief Finance Officer

Significant NAB Governance Changes During 2008 (cont)

- **Focus** - The order of meeting agendas:

  - Shift from BAU reporting to forecast positions and risks.
  - Emphasis on key issues of: capital adequacy, liquidity & funding

- **Engagement -** greater frequency:

  - Chair of PBRC meeting with Chairs of the subsidiary banks' risk committees
  - Board Committees meeting more frequently - "as necessary"
  - Regular flow of "updated information" between meetings

- **Review**
  – Higher risk business activities and their strategies.
  - Meeting outcomes and issues discussed by secretaries to committees.

- **Consequent Impacts -**

  - Capital and funding requirements have changed
  - Risk appetite position reconsidered

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