



Financial Training

Risk Management, Outlook

**Risk Management in Banking, Dar es Salaam
2006**

Financial Risk Management

Agenda

- Introduction
- Looking at the future
 - 10 issues to address
- Key issues for success
 - Growth and business development
 - Efficiency and cost management
 - Integrated risk-return view
 - Off shoring
 - Risk and capital management
 - Economic capital
 - Basel II
 - Enterprise Risk Management
 - Chief risk officer
 - Governance and reporting
 - Balance compliance vs. performance

Introduction

- Favorable economic outlook in most countries
- The Financial Services Industry is characterized by fewer bigger companies (majors)
- Tier 1 capital for top 1000 bank rose by 15 percent in 2004 to US \$ 2740 bn.
- The majors have successfully penetrated new geographic and product markets
- The balance of economic power is shifting
- The contrast between US economy and EU expands

Introduction

- **Cost management is top of the executives agenda**
 - Cost/income ratios have improved from 63 percent to 56 percent in Europe. 1995 to 2005.
- **The Financial Services Industry is the most highly regulated in the world**
- **Regulators are raising the bar and also collaborating with each other which has led to greater consistency and transparency**
- **Regulator requirements are still viewing as merely a compliance issue**
- **Risk and capital management are core processes and more integrated with corporate strategy and culture**

Looking at the future

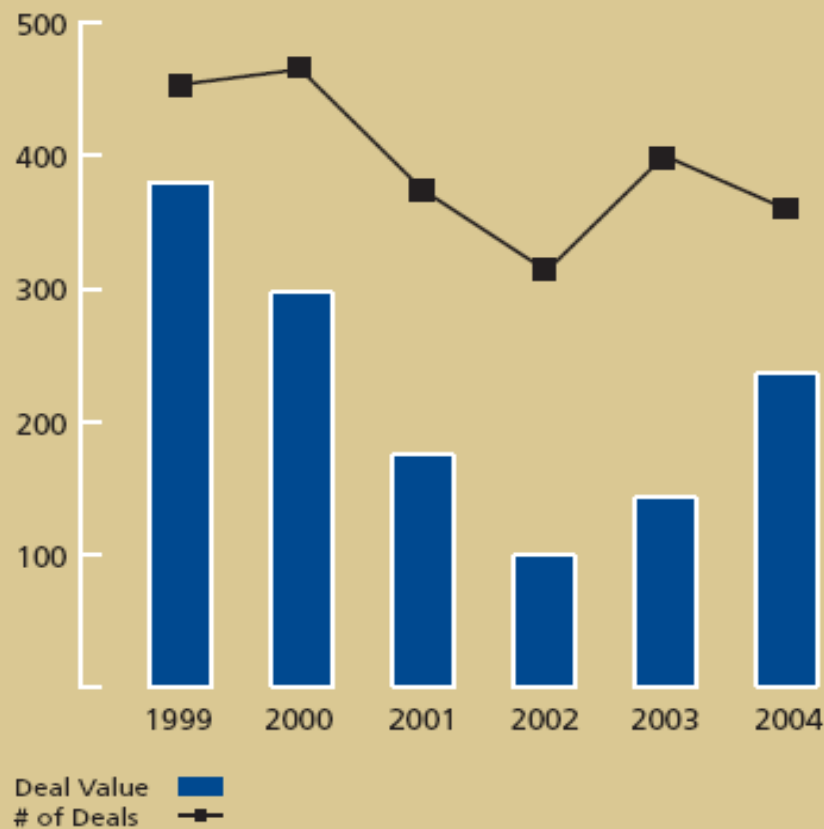
- **Consolidation: Achieving strategic balance**
- **Retail renaissance: Bonding with customers**
- **Grooming the next generation of talent**
- **The off shoring decision**
- **Transforming the finance function**

Looking at the future

- **Monitoring the credit quality**
- **Achieving comprehensive governance of risk management**
- **Corporate governance: Boards in the spotlight**
- **Basel II: Driving enterprise Wide change**
- **The last stretch for IAS 39 implementation**

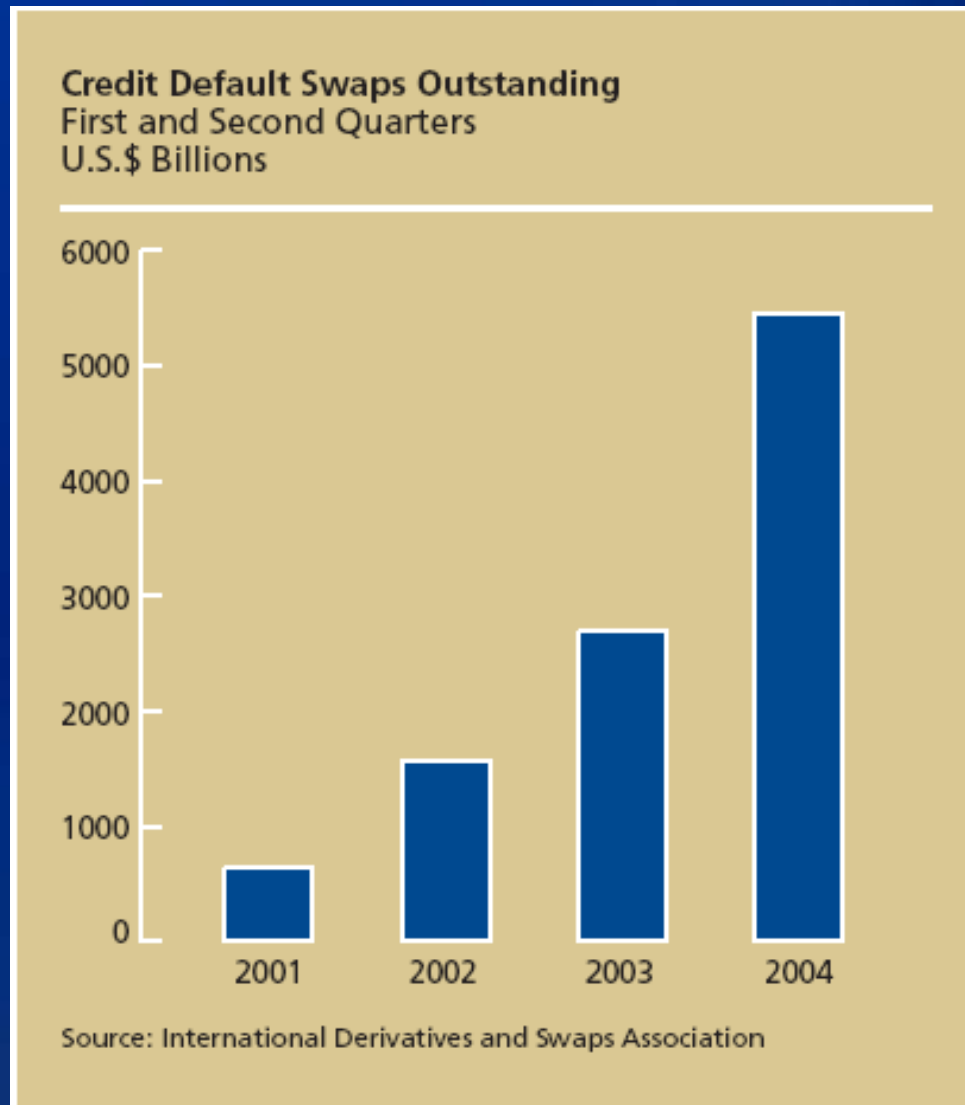
Worldwide banking M&A

Worldwide Banking Mergers and Acquisitions
U.S.\$ Billions



Source: Thomson Financial

Credit default swaps outstanding



Overall responsibility for risk management



Growth and business development

- The majors will continue to expand
- Smaller players will be able to compete by concentrating on specific geographic or product areas

Choices have to be made

Growth and business development, cont

- **The global financial service industry has to manage the following key industry issues to be successful:**
 - Efficiency and cost management
 - Risk and capital management
 - Governance and reporting

Efficiency and cost management

- Falling sales and increasingly squeezed margins
and
- The price competitive nature of the industry

Has led to focus on efficiency and cost management

- Integrated risk-return view
- (Outsourcing)
- Off shoring

Integrated risk-return view

- Banks need to focus on business performance (cost and revenue together)
- Have to find a way to measure the value brought to the organization, i.e. Economic Value Added (EVA)
 - **Net operating profit minus charge for the cost of capital**
 - **EVA is linked to shareholder value over time**
 - **Used to evaluate business decisions**
- For identifying key value and performance indicators balance scorecards and value driver trees can be used

Integrated risk-return view, cont

- An integrated approach to performance requires understanding of three key areas:
 - **Primary processes**
 - Retail banking, Corporate banking, Investment banking and transactions
 - **Support processes**
 - Accounting, financial control, human resources
 - **Remaining administrative costs**
 - Real estate, marketing, IT

Risk and capital management

- Development of more sophisticated tools and techniques because of
 - **Regulatory requirements**
 - **Recognition that better understanding of the business will result in better strategic decision**
- The range of risks facing organizations will become even more complex
- Fraud is seen as one of the biggest problems (US\$1Trillion)

Risk and capital management

- Four key areas within risk and capital management which I would like to address
 - Economic capital
 - Basel II
 - Enterprise Risk Management
 - Chief Risk Officer

Economic capital

“Economic capital is the capital banks set aside as a buffer against potential losses inherent in a particular business activity”

- Economic capital is rapidly moving to center stage in the banking industry
- Regulators is requiring banks to demonstrate
 - **How business models ensure that risk can be safely borne**
 - **Whether the level of capital is consistent with the risk profile**
- Problems to be solved:
 - **Acquiring the necessary data**
 - **Consolidating portfolio data**

Economic capital

- The real challenges is use Economic capital at a strategic level
 - **Allows the board to determine the optimal level of capital and risk appetite**
 - **Allocation of capital to individual departments, products etc**
- This opens the way to
 - **more effective decision making**
 - **Risk based-pricing**
 - **Derive hurdle rates**
 - **Determine shareholder value**
 - **Communicate the banks risk and capital management to shareholders, rating agencies and investors**

Basel II

With the publication of the final "revised" Basel II framework together with local regulatory publications, the waiting period is over and banks must take action!

Basel II is Schedules to be implemented at latest January 1, 2008

Figure 7: Minimum Capital Requirements

Basel I

$$\frac{\text{Total Capital}}{\text{Credit Risk (old) + Market Risk}} = \frac{\text{The bank's capital ratio}}{\text{(minimum 8\%)}}$$

Basel II

$$\frac{\text{Total Capital (unchanged)}}{\text{Credit Risk (new) + Market Risk + Operational Risk}} = \frac{\text{The bank's capital ratio}}{\text{(minimum 8\%)}}$$

Source: Bank for International Settlements (BIS), 2001.

Basel II, cont

- Basel II will give a wide range of business implications and risk management challenges

- Banks will be asked to implement an enterprise-wide risk management framework that ties regulatory capital to economic capital.
- Non-banks outside the scope of Basel II will not face its compliance challenges but may nonetheless be pushed to use it as a competitive benchmark.
- Banks will need to collect and disclose new information and face the implications of increased transparency.
- Rating agencies have new prominence as a result of the Basel II framework and thus could experience new competition.
- Regulators are challenged to provide a level playing field in their jurisdictions and internationally as the Basel Committee's recommendations are implemented by legislatures in various countries. In addition, regulators need to ensure that their examiners are adequately trained to assess bank's compliance with the new capital rules.
- The global banks could experience extended trends toward increased securitization as financial institutions adapt to Basel II requirements.

Basel II

- Two questions that I would like to look at
 - **How well are the banks prepared for Basel II?**
 - **In what way will Basel II effect the industry and different banks?**



FINANCIAL SERVICES

Results of the Basel survey 2004/2005

June 2005

ADVISORY

Overview

- Annual survey, first conducted in 2001
- 2004 year's survey represents 252 financial institutions from 36 countries.
- Over half of the respondents consider themselves to be a retail bank
- Approximately 60 percent have a balance sheet size over US\$5 billion
- The survey was conducted between November 2004 and January 2005

Executive summary: (1/4)

Status of the Basel II projects

- More than 90 percent of respondents have started a Basel project
 - More than half of the participants are still in the pre-study phase in Pillar II, 25 percent have not even started a Pillar II project
 - For Pillar III it is even worse, 35 percent of participants have not started yet, with another 18 percent who only performed a high level assessment
 - Approximately 20 percent have started with the implementation for Credit Risk, and less than 20 percent for Operational Risk
 - Supervisory review and capital assessment (Pillar II) are banks' main cause for concern, followed by the timing of implementation
- **Considering the implementation time frame until 2008 and the project complexity, banks seem to be behind schedule**

Executive summary: (2/4)

Benefits from Basel

- **In order of priority, the following benefits are seen from Basel II:**
- **Top priorities:**
 - Improvement of overall Credit Risk Management
 - Improvement of Operational Risk Management
 - Enhanced reputation due to advanced risk management techniques
- **Other priorities:**
 - Possibility of diversified margining and product pricing
 - Reduction in operational losses

Executive summary: (3/4)

Obstacles to implementation

- **Lack of data for determination of Loss Given Default (LGD) and of operational risk losses**
 - **Lack of flexibility in the IT area and interfaces**
 - **Cost of compliance with Basel II**
 - **In Americas and ASPAC region, the required business process re-design**
 - **In ASPAC region: a lack of data for determination of Probability of Default (PD), a shortage of credit risk management experts and a lack of operational risk governance structure**
- **Main obstacles are the lack of data and the costs of compliance**

KPMG defined regions are: Americas = Canada, United States and Latin America; ASPAC = Asia Pacific; EMA = Europe, Middle East and Africa

Executive summary: (4/4)

Regional deviations

- **Almost 60 percent of respondents in the ASPAC region apply the Standardised Approach for credit risk, whereas the Americas have replaced this approach with more advanced techniques.**
- **As a consequence, credit risk is a big concern of ASPAC banks (63 percent) in contrast to the Americas where it plays a much smaller role (approx. 35 percent).**
- **For operational risk, the Basic Indicator Approach and the Standardised Approach are the preferred method in the ASPAC region. Use of more advanced methods remains scarce.**

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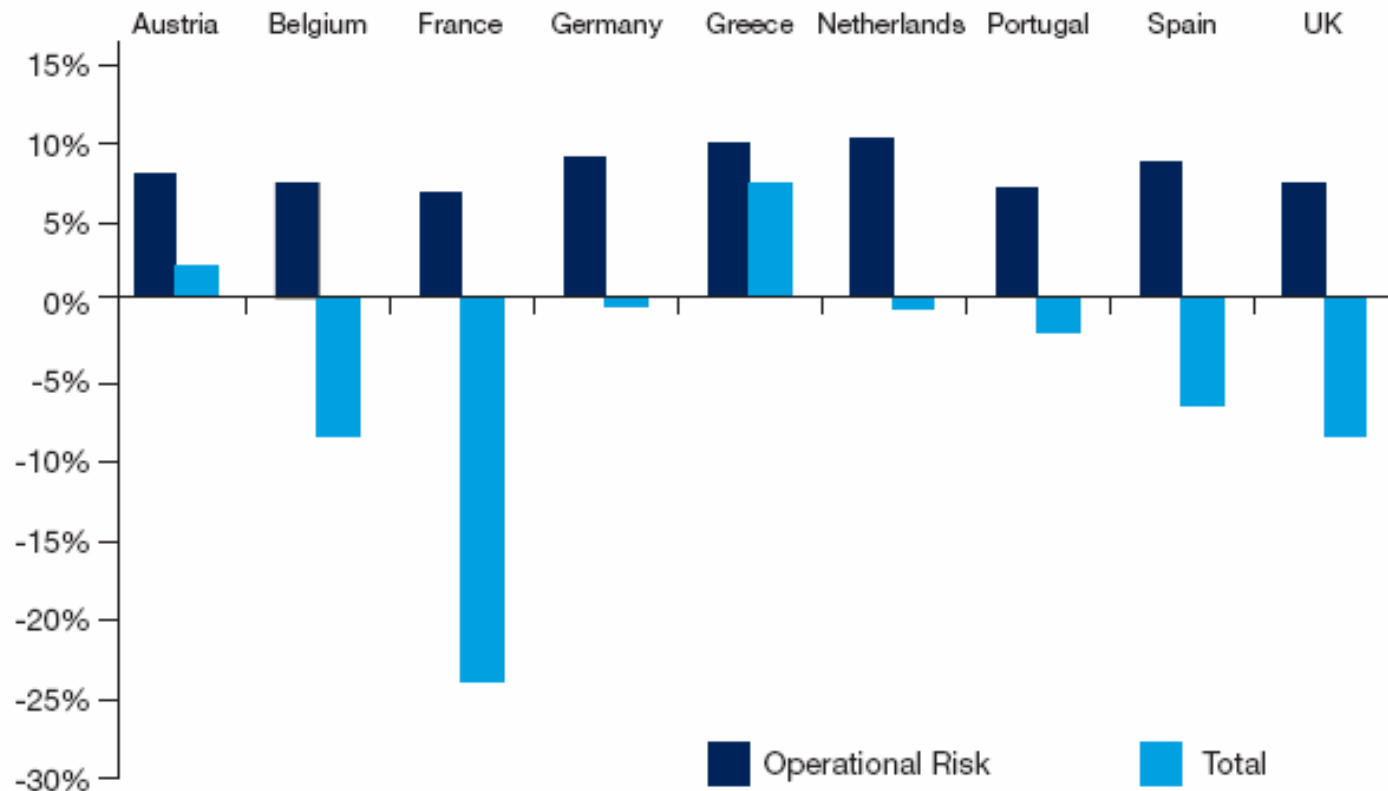
Basel II, PWC study

PricewaterhouseCoopers “Study on the financial and macroeconomic consequences of the draft proposed new capital requirements for banks and investment firms in the EU”, April 2004, published by the European Commission in April

- **The effects are quite well known due to the three Quantitative impact studies**
- **5 percent reduction of the capital in the EU economy**
- **Credit risk capital for corporate, retail and SME will reduce**
- **Big difference between countries and banks**
- **Smaller banks will benefit more than bigger banks!**
 - The reduction that bigger banks can see in their retail portfolio is often offset by increased capital to support other exposures

Basel II, PWC study

Expected change in capital requirements per country^a credit and operational risk



Source: Quantitative Impact Study (QIS) country reports, EU Commission analysis, PricewaterhouseCoopers analysis

Basel II, PWC study

Impact on Group 1 and Group 2 banks

	Capital change (%)		Capital change (€ billion)		
	Group 1	Group 2	Group 1	Group 2	Total
Standardised	+2%	+2%	-	+7	+7
Foundation IRB	-2%	-15%	-11	-53	-64
Advanced IRB	-3%	-34%	-10	-23	-33
Total	-3%	-9%	-21	-69	-90

Source: QIS3, PricewaterhouseCoopers analysis

Basel II, other impacts

- **Impacts on**

- Pricing

- Economic capital models allows banks to quantify risks better and therefore also price. However, even where economic capital models are used as a pricing tool, they are not applied mechanically.

- Merger activity

- Merger activity (for example to release capital from an institution using the Standardised Approach) will not increase. However, risk-based capital assessment is an extra consideration that banks will need to factor into their capital allocation decisions. It is possible that small institutions will seek to acquire other small institutions to benefit from scale economies in systems and data.

- Macro economy

- Except from the decrease of 5% of capital that will lead to an increase of 0,1% EU GDP it is very hard to guess.

Basel II, summery

Those with a possible advantage:

- Prime customers
- Well-rated entities
- Small and medium-sized businesses
- High-quality liquidity portfolios
- Collateralized and hedged exposures
- Low credit and operational loss experience
- Strong risk management processes

Those with a possible disadvantage:

- Higher credit risk individuals
- Uncollateralized credit
- Specialized lending (in some cases)
- High historical credit and operational loss experience
- Weak risk management processes

Enterprise wide risk management

Enterprise risk management is a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

Definition according to COSO

Enterprise wide risk management

- **What is ERM?**

- Standard risk management process, an integrated view of all risks and a focus on relating risk to business objectives

- **According to Deloitte (march 2004)**

- one in five had no ERM program
- 53% believe that the benefits of ERM are greater than the costs

Enterprise wide risk management

- **What is ERM?**

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- one in five had no ERM program
- 53% believe that the benefits of ERM are greater than the costs

What are the drivers for investing in ERM?

Internal

Musical Chairs: A new CEO or Chair of the Board / Audit Committee who is open to fresh approaches

Flex from the centre: Concerns at HQ about the level of control they have over a diverse business

Expansionitis: The company is growing fast and is struggling to maintain control over operations

A risky business: Major changes in business direction or the dynamics of an industry

Ticking off: Ongoing Audit Committee or major shareholder complaining about a lack of internal control

Keeping up with the Jones's: Executive management want to maintain parity with the practices of their peers

External

Share shocker: Nasty surprises that lead to a falling or poor performing share price

Born in the USA: Sarbanes-Oxley controls reporting is time-consuming and must deliver back more than just compliance

Capital Concerns: Credit ratings agencies taking an interest in governance and risk management capabilities

Rules and more rules: New trends in the regulatory environment at home and abroad

PLC Pressure: Demerger or listing on a new exchange that requires additional governance and compliance processes

Losing face: an event that could put the company's reputation at significant risk of damage

There are different stakeholders involved in ERM

Internal Stakeholders

Executive management

"I want to use risk information to drive improved performance across by business."

Business / Divisional managers

"Risk management should help me focus resources on the areas that are really critical to my business unit."

Non-executive directors

"I want improved dialogue surrounding significant risks in the boardroom."

Employees

"I want to know that we are considering risk when we're taking decisions."

External Stakeholders

Regulators

"We want to see organisations being more responsible when taking risk."

Investors

"I will reward companies in the long term for honest and transparent risk disclosure as this builds 'trust' between us which I rely on."

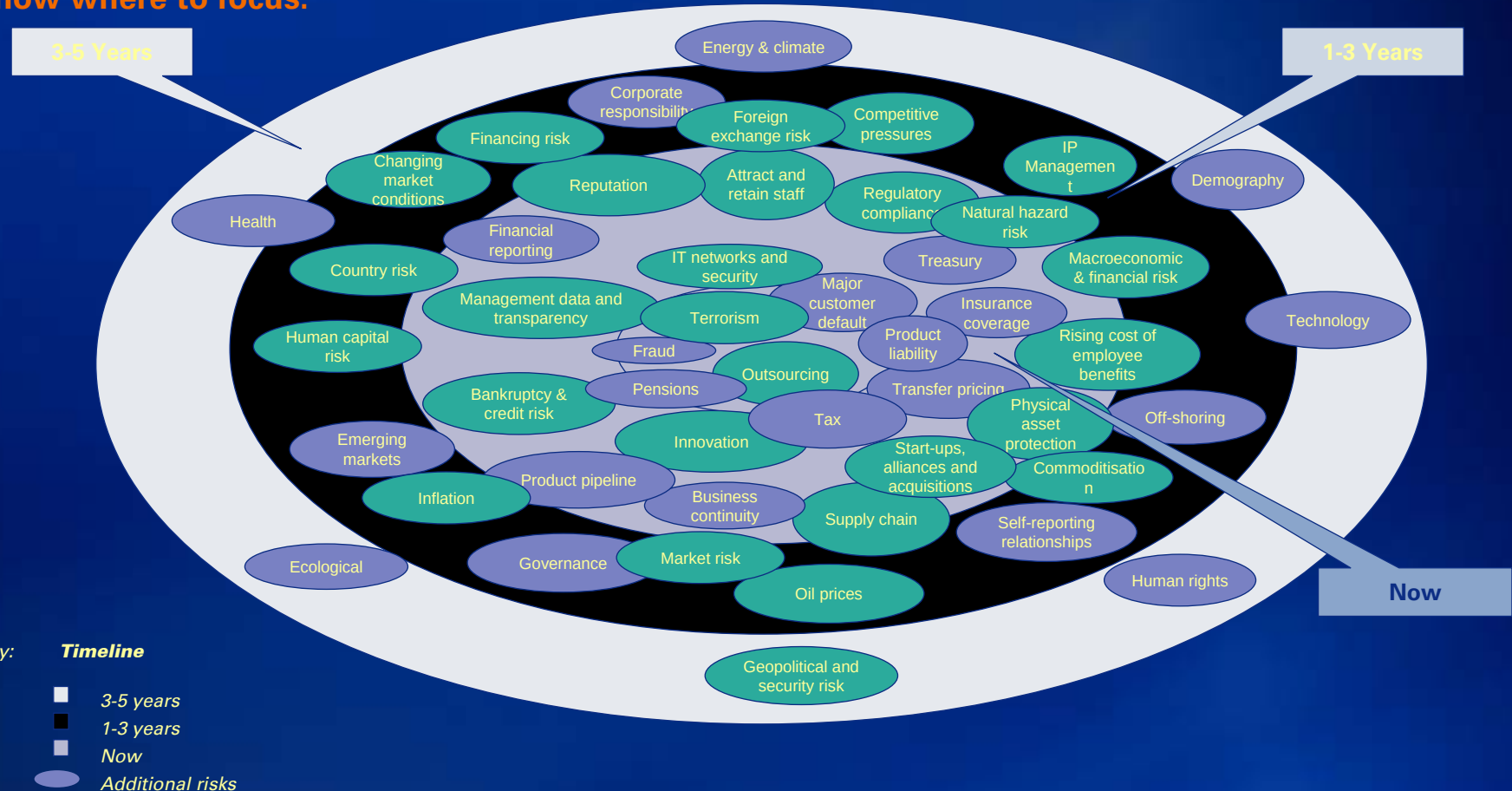
Advisors

"... Companies can expect a 10 to 12 percent boost to their market valuation by going from worst to best on any single element of governance." McKinsey survey, 2004

Source: KPMG LLP (UK) clients, unless stated otherwise

Our experience of a typical risk profile confirms there are broader risks to think about

When you look at a typical risk profile now compared to three years ago there are many more potential risks. To make sense of this, you need to think about the time horizon to know where to focus.



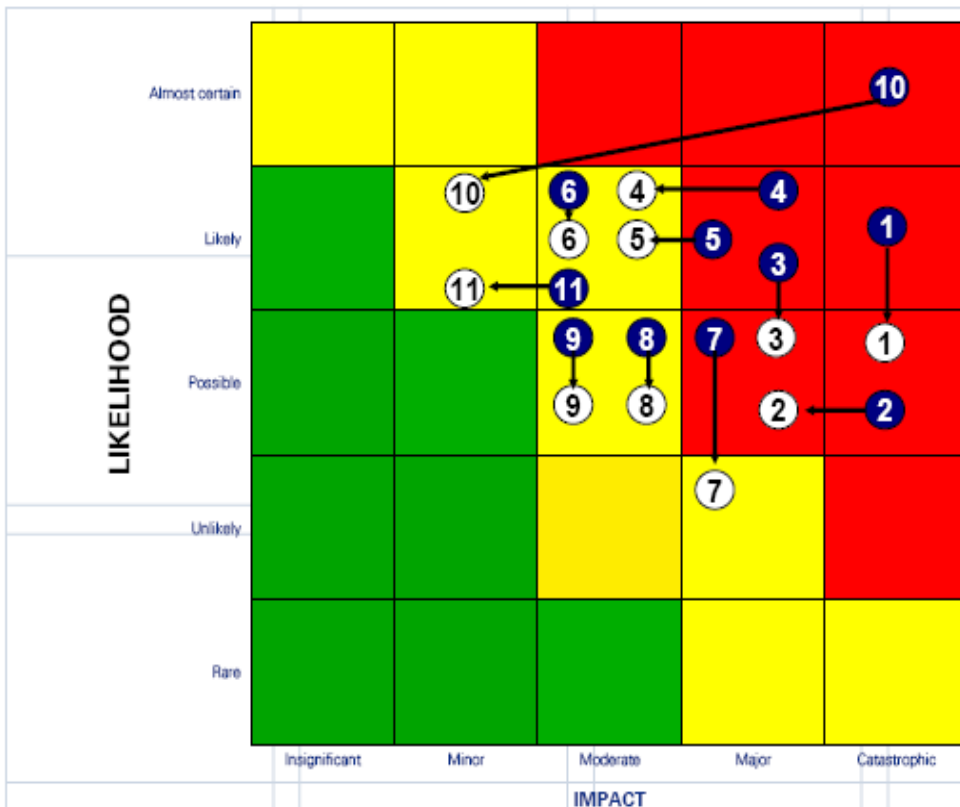
Source: KPMG LLP (UK)'s aggregated experience facilitating client risk assessment workshops

Enterprise wide risk management

Enterprise Risk Management (ERM) helps our clients to design and implement an organization-wide approach to the identification, assessment, and management of risk in a cost-effective manner.



Enterprise wide risk management, Probability impact grid



Key Risks:

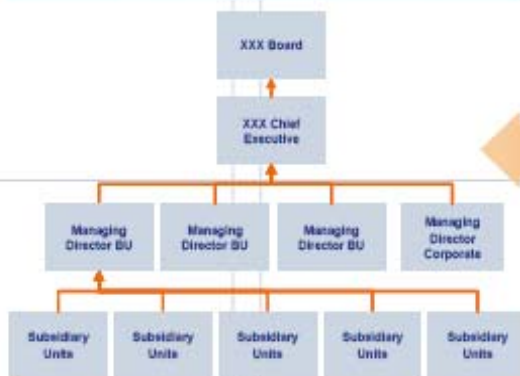
1. Material breach of banking covenants
2. Loss of key facility / infrastructure and / or IT infrastructure and systems
3. Increased competition leading to both pricing and market pressures
4. Increased reliance on quality of management information and information systems
5. Failure to develop and consolidate global management and information systems
6. Overcapacity in the market results in low utilisation and reduced profitability
7. Fraud
8. Lack of formal crisis management communication process
9. Inability to operate effectively / take advantage in the Pacific due to increasing growth of market and economic power in region
10. Unfavourable economic conditions (world trade, FX)
11. Inability to attract, retain and motivate staff and lack of succession planning

Enterprise wide risk management



Example escalation requirements				
	Risks before controls	Reputation	Health, Safety & Environment	Commercial
Critical	Classification and mitigation plan reviewed and approved by the CEO. Monitored and reviewed monthly. Assurance plan reviewed at Group level	Immediate and continuous reporting to, and action by, the CEO	Immediate and continuous reporting to, and action by, the CEO	Immediate and continuous reporting to, and action by, the CEO
High	As above except: Review and approval by BU President Assurance plan reviewed at BU level	Immediate reporting to, and action by, the CEO	Immediate and continuous reporting to, and action by, the CEO	Immediate reporting to, and action by, the CEO
Moderate	As above except: Review and approval by BU President	Notification to, and review by, Group Managing Director	Notification to, and review by, Group Managing Director	Notification to, and review by, Group Managing Director
Minor	Approach to be determined by BU	Notification to, and review by, BU President	Notification to, and review by, BU President	Notification to, and review by, BU President

Example revised reporting structure:



Example board report content

		Annual	Quarterly
Revised annual and quarterly reporting content:	Commentary on current business environment and appetite for risk	Full	Updated
	Key risk assessment - highlighting new/changed risks from previous year	Full	Update - changes & progress against actions
	Key operational risks - highlighting new/changed risks from previous quarter	Update - changes & progress against actions	Update - changes & progress against actions
	Risk management development plan - outlining how the reporting entity plans to maintain and improve risk management	Full	Progress update
	Performance monitoring - self-assessment of risk management performance (against scorecard) and independent assurance opinion (Internal Audit)	Full	

Enterprise risk management

- Significant ERM implementation challenges
 - **System integration and automation (51%)**
 - **Data cleanup and consolidation (45%)**(According to CCH Incorporated)

Chief Risk Officer

- **Why Chief Risk Officer (CRO)?**
 - **Creation, or formalisation, of CRO role has arisen mainly due to the following key drivers:**
 - **Sophisticated response to the changing marketplace. Consequently, CRO's have arrived to develop strategies and solutions.**
 - **Modern risk management thinking recognises that a fragmented, "silo" approach to risk management is inefficient for an organization with interrelated risks. Someone needs to manage the co-ordination of risk management activity organisation wide.**
 - **Regulatory bodies, rating agencies and equity analysts have placed the burden of effective and integrated risk management on the boards of directors of major corporations.**
 - **CRO's bring an integrated perspective to risk management and an advanced level of risk transparency.**

Chief Risk Officer

- According to CCH Incorporated (2004)
 - **81% reported that they have a CRO (62% 2002)**
 - **75% of CROs report to their CEO or board of directors**
 - **CROs primary responsibilities are**
 - Risk analytics and reporting (85%)
 - Developing controls, policies and monitoring compliance (79%)
 - Monitoring of risk exposure versus limits (74%)
 - Independent verification of risk methodologies (70%)

Chief Risk Officer

- **Benefits of the CRO role:**
 - Enables true cross-organisational/functional appreciation of risk
 - CRO can communicate more effectively with other C-grades – improving the alignment of risk management strategy with corporate objectives.
 - Appointment signals the board commitment to risk management at the highest level
- **Appropriate CRO attributes:**
 - Operate effectively at all levels of the business
 - Broad understanding of all areas of the business
 - Able to organise and motivate others
 - Possess the authority and resources to monitor the process
 - Understand the actual risk controls in place
 - Have capability to accumulate and summarise risk reports from different functions/divisions and establish continuous dialogue with top management

Governance and reporting

- Increased demands from
 - **Legislators**
 - Sarbanes Oxley
 - IFRS
 - **Customers**
 - **Shareholders**
 - **Rating agencies**
- With a stream of new regulatory requirements the companies have to

“Balance compliance and performance”

Governance and reporting

Figure 3 The Performance/ Compliance balance



Source: KPMG International 2005

Figure 4 Pressures on the financial reporting infrastructure



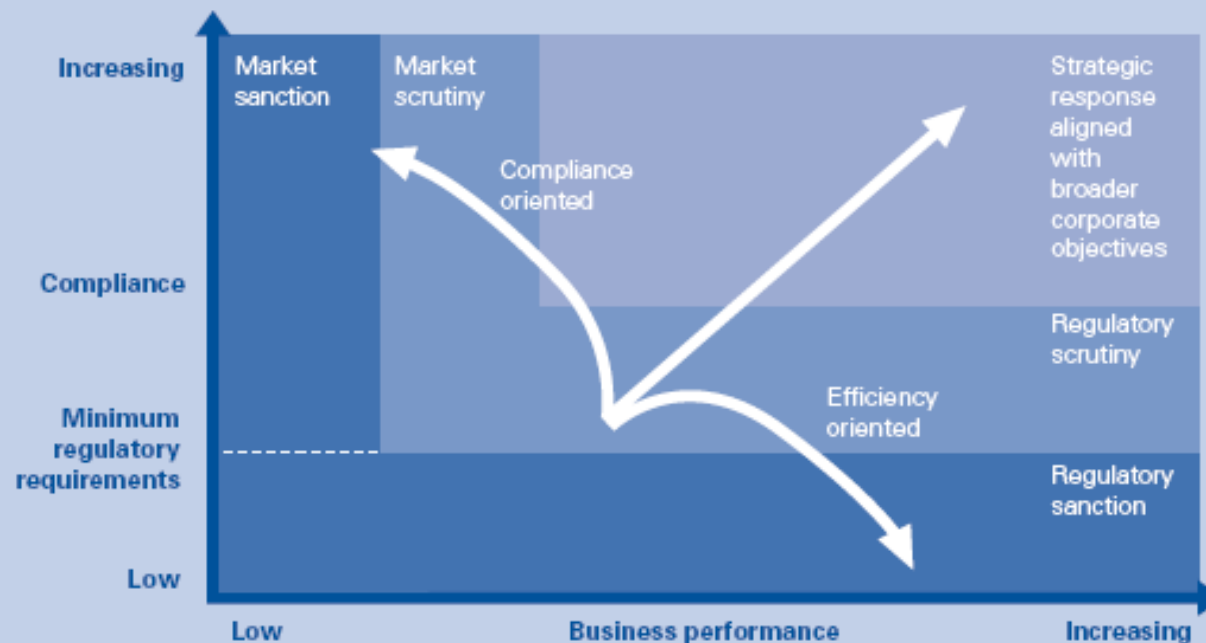
Source: KPMG International 2005

Governance and reporting

- IFRS, Basel II, Solvency II, SOX plus country specific initiatives
- Regulatory demands leads to high cost, in terms of time and resources.
- The finance function have a twofold role, handling the regulatory requirements and support the business to better performance

Governance and reporting

Figure 1 Process ownership establishes a framework for driving sustainable improvements in business performance while improving the overall control environment, allowing a move into the “green zone”



Source: KPMG International 2005

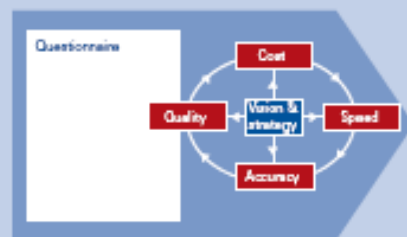
Governance and reporting

- **Moving from compliance to performance**
 - Compliance activities should be viewed more positive
 - IFRS increases transparency and impacts budgeting and forecasting
 - SOX brings more focus on internal control
 - Strengthen internal controls reinforces the trust placed by the investors
- **The challenge for the finance function is to better understand the relationship between risk, capital and profits**

Governance and reporting

Figure 6 4 steps of finance integration assessment

Conduct interviews



- Launch project
- Identity interviewees
- Tailor assessment questionnaire
- Gather data (KPIs)
- Conduct executive focus interview with CFO
- Conduct interviews with other identified interviewees

Analyze results



- Benchmark results against database and experience
- Analyze results from interviews
- Prepare results analysis
- Conduct meeting with project sponsor to present results analysis

Define priorities and building blocks



- Define the prioritization criteria to be used
- Schedule and conduct prioritization workshop to identify and define priorities
- Identify building blocks for the path forward

Develop transformation roadmap



- Schedule roadmap workshop
- Conduct workshop with project sponsor to develop transformation roadmap, based on identified priorities
- Estimate high-level budget
- Identify resource requirements and needed skills
- Draft roadmap to help achieve better practices

Source: KPMG International 2005

Final remarks

- If you want to be successful you have to manage the following key industry issues:
 - Efficiency and cost management
 - Integrated Risk Return view
 - Outsourcing and off shoring
 - Risk and capital management
 - Economic capital
 - Basel II
 - ERM
 - CRO
 - Governance and reporting
 - Balance compliance and performance

Thank you !!!!!!!