

Strengthening Risk Governance in Banks

Lessons From the Design and Implementation of the Forum's Financial Markets Recovery Project



Lessons Learned

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The global financial crisis exposed weaknesses in banks' corporate governance systems, particularly their risk management policies and procedures. To help banks address these problems and thereby prevent, or at least mitigate, future systemic banking crises, the Forum launched the Financial Markets Recovery Project. The lessons from the project design and rollout can inform the work of bank board directors and training professionals working with financial institutions.

Background

It's early in 2008, and the world's financial system is in crisis. Fears of an absolute meltdown abound. The dominos are falling. Liquidity in the developed markets dries up. As the problems mount, a severe economic downturn erupts worldwide, forcing governments to pump unprecedented amounts of capital into their national economies and to rescue banks, investment firms, and others. . .

Among the many causes fueling that economic calamity, one key factor was the failure of corporate governance in banks and financial institutions. Board directors failed to rein in excessive leverage, to challenge business models based on "irrational exuberance," to account for complex, hard-to-value derivatives, and to manage risk exposures. And, they failed to implement "triage" to contain the fallout and promote economic growth.

In the midst of this whirlwind, the Global Corporate Governance Forum was engaged to contribute its expertise to a multi-agency response to the crisis. To start, the Forum experts put the global financial crisis into context. That context is not a pretty picture, but it is informative: The global financial crisis is only the latest in a series of recent, frequent systemic challenges to the banking sector. Each time, the regulators responded and managed the immediate crisis. But the Forum planners began to wonder whether something was amiss systemically, and, if so, whether the Forum could create a project to treat that systemic cause. After all, if poor governance—poor risk governance in particular—was a contributing factor in each of those situations, might it be possible that improving a bank's corporate and risk governance could prevent, or at least mitigate, systemic banking crises

ABOUT THE FORUM

The Global Corporate Governance Forum is the leading knowledge and capacity building platform dedicated to corporate governance reform in emerging markets and developing countries. The Forum offers a unique collection of expertise, experiences, and solutions to key corporate governance issues from developed and developing countries.

The Forum's mandate is to promote the private sector as an engine of growth, reduce the vulnerability of developing and emerging markets to financial crisis, and provide incentives for corporations to invest and perform efficiently in a transparent, sustainable, and socially responsible manner. In doing so, the Forum partners with international, regional, and local institutions, drawing on its network of global private-sector leaders.

The Forum is a multi-donor trust fund facility located within the IFC, co-founded in 1999 by the World Bank and the Organisation for Economic Co-operation and Development (OECD).

in general, irrespective of the proximate cause and the specific institutions involved? Could improving bank governance make banks and the banking system more robust?

Carefully, those Forum planners began to define the intervention that would become the Financial Markets Recovery Project (FMRP). In addition to a thorough literature review, the Forum and its consultants conducted first-person consultations with more than 100 bankers, bank directors, regulators, and other experts, as well as with the Forum's own Private Sector Advisory Group and experts from the World Bank, IFC, International Monetary Fund, Bank for International Settlements, and central banks around the world. The project also drew extensively on the risk management experience of Eastern European banks and

financial institutions, particularly risk governance lessons that grew out of policy responses to the global financial crisis. This work was made possible through the generous contributions of the governments of Austria, Luxembourg, and Netherlands.

Guided by the hundreds of comments from those events and one-on-one meetings, the experts designed a project to create capacity to train bank boards of directors in emerging markets and to add to the knowledge base of boards of directors regarding bank risk governance and corporate governance.

For more information, visit:
www.gcgf.org/boardleadership



Forum consultations with stakeholders, Paris, June 2009.

Fundamentals of the Financial Markets Recovery Project

At its heart, FMRP consists of three key elements:

- **The *Governing Banks* training supplement.** This new sector-specific training curriculum is designed to be taught in conjunction with the Forum's *Corporate Governance Board Leadership Training Resources* toolkit.
- **Working with a local partner in each market.** To build training capacity in a market, the Forum houses the FMRP in a local institution, such as an institute of directors or a corporate governance association. In each market, the Forum also works closely with local offices of IFC Advisory Services.
- **Developing the informal and formal networks**—of bankers, directors, banking experts, and regulators—that exist in every market. Involving bankers and regulators in the local rollout of the FMRP reinforces their interest and commitment.

The Financial Markets Recovery Project builds on the Forum's successful *Board Leadership Training Resources* toolkit. The *Resources* toolkit and the training program built around it,

known as "training of trainers," or ToT, aim to strengthen capacity of trainers who, in turn, train board directors in emerging markets and developing countries.

The *Training Resources* rely on the experiential learning cycle methodology suitable for adult learners, and provide a comprehensive curriculum with PowerPoint presentations, case studies, and a modular curriculum design that allows for quick customization. The comprehensive learning materials encompass all aspects of board leadership, with particular emphasis on strategy formulation, financial controls, supervision and reporting, and risk management. The *Governing Banks* supplement adds to this an in-depth explanation of five topics: the governance of risk management in financial institutions, banks' role in the economy, risk and the economics of banking, bank regulation and oversight, and risk management and measurement. This gives the trainers the ability to mix and match parts from both the *Governing Banks* supplement and from the main *Board Leadership Training Resources* toolkit to focus the



training on the areas of greatest need in each market.

Both the “regular” and FMRP training-of-trainers events are highly interactive. Training programs by other providers often rely on prescriptive information and an overt compliance focus, overlooking the necessary behavioral and leadership reforms required to improve board practices. By

contrast, the high degree of participant input and interactivity that is the hallmark of the ToT workshops encourages the trained directors to carry that interactivity forward and to be more engaged in board deliberations.¹

Lessons from the project design and implementation

The Forum began FMRP implementation in May 2009 in the midst of the unfolding global financial crisis, immediately following the heads of state G-20 London meeting and just prior to the United States introducing its Financial Regulatory Reform Plan. Based on the *Governing Banks* supplement, FMRP started as a pilot in South East Asia (anchored in Indonesia) in March 2010, followed by official rollout in Bangladesh in March 2011. Advanced planning is under way in a number of other countries and regions.

“IFC-Forum in this initiative of training of trainers will help bank directors better understand their roles and responsibilities and motivate them to be proactive change agents. I am therefore looking forward to this initiative yielding us in the coming months a substantial group of bank directors who are well-trained and motivated to safely and soundly govern their banks.”

Dr. Atiur Rahman

Governor of the Central Bank of Bangladesh

FMRP has been well-received by banking and corporate governance experts worldwide and welcomed by regulators in the markets where it is being introduced. The project is yielding early but important lessons in developing board training materials and establishing self-sustaining capacity to train bank board directors, key among them:

1. The banking sector really is different.

In virtually every meeting and conversation, the Forum experts received one bit of advice again and again: “The banking sector really is different.” We were impressed by the consistency of the message that few, if any, other business sectors have such extreme effects on the real economy; few, if any, other businesses have the inherent fragility of banks built into their business models; and few, if any, require such domain expertise from their boards.

1. To date, the Forum has organized ToT programs for 596 trainers from 46 countries.



Team discussion during the first FMRP training of trainers in Bangladesh, March 2011.

Part of what makes banking such a singular sector is the element of speed. Banks are inherently highly leveraged institutions, constantly walking a fine line between risk and reward. If a board of directors of an industrial company makes a mistake, it may have time to reverse course and repair the damage. But, because the integrity of banks depends on the confidence of its depositors, liquidity crises can happen in days, or *hours*, once that confidence is shaken. As the legendary investor Warren Buffett observed, “It takes twenty years to build a reputation and five minutes to ruin it.” Remember all those pictures of lines around the block as depositors tried to withdraw their savings from Northern Rock in the United Kingdom? That’s why a crisis of confidence is called a *run* on the bank, not a walk or a stroll. Bad risk decisions or insufficient oversight by a board can result in a bank that was worth billions one day being out of business the next. There are few other businesses in which poor corporate governance manifests itself so quickly—or with such profound consequences.

The CAMELS approach described in *Governing Banks* is used to analyze risk exposure in six areas: **C**apital adequacy; **A**sset quality; **M**anagement, and particularly risk management; **E**arnings quality; **L**iquidity; and **S**ensitivity to market risk.

It was in response to this issue that the Forum and its partners produced a *Governing Banks* supplement to complement its more general *Board Leadership Training Resources* toolkit. As helpful as that toolkit is to most industrial and service companies, it was abundantly clear that bank directors needed more information and guidance, namely a specific curriculum covering risk governance.

2. Bank boards need extensive domain expertise to enable them to focus on risk governance.

Systematic risk governance has emerged as best practice for many companies. For banks, where the relationship between certain types of risk and profitability are tightly interwoven, it is particularly important. For example, a bank can increase profits by making riskier loans and charging more interest, but that affects asset quality, which became a major cause of banks’ problems during the financial crisis. Or, banks can reduce reserves and lend more of their deposits, thereby earning more, but that increases its liquidity mismatch, making it more vulnerable to a run.

As might be expected, banks have developed complex systems to monitor a variety of risks. But, unless a board has an appropriate level of knowledge about the strengths, weaknesses, applicability, and time horizons of those systems, how is it to fulfill its risk oversight function effectively? As the *Financial Times* reported in the midst of the global financial crisis, “One Wall Street executive admits that it would not be too difficult for him to present financial information to this board ‘in such a complex way, that people would be prevented from asking whether the emperor is naked, for fear of looking stupid.’”

To be effective, a director needs to be a full participant in board matters. But, directors who do not understand a particular issue and fear being embarrassed by having their rudimentary knowledge exposed, are naturally disinclined to ask questions or offer opinions. This is why effective risk governance demands that each director fully understand the breadth of risks faced by the bank.

Directors add value to a bank board when they have financial expertise, are aware of risk fundamentals and techniques, are able to manage dynamics with executives, and can demonstrate emotional intelligence in addressing issues constructively.

Governing Banks reviews common bank risk management techniques. It explains the sources of risk as well as how banks typically measure and manage them. Its contents range from reviewing the differences between scenario testing, stress testing, and sensitivity analysis, to the limits of a mathematical model, to the varying ways to manage risk (such as market management through hedging, or commercial management by emphasizing certain bank products over others). In short, *Governing Banks* gives directors what they need to determine whether the emperor really is wearing any clothes.

After all, as one non-executive bank director commented, “Some people ask if we are risk-seeking or risk-avoiding. I profess that we seek to be risk-aware. The one set of risks for which you are likely not to be compensated are those risks you do not know that you are taking.” For him, the training underscored the need to enhance his bank’s risk management policies and procedures and to support directors in their efforts to master key concepts necessary to analyze the situation and make decisions.

3. Training of bank directors needs both global and local contextualization.

Training programs take root when international best practice and contemporary global developments go hand-in-hand with local experience and case studies. This allows the training to address local-specific factors such as, for example, banking regulation.

In its recommendations following an analysis of the financial crisis, the Organisation for Economic Co-operation and Development (OECD) advised that the “fit and proper person test” for board members “extend to the technical and professional competence of board members, including general governance and risk management skills.”

Banks, of course, are among the most highly regulated companies in virtually all jurisdictions in the world. Most jurisdictions require a bank to be licensed, which serves both to guarantee minimum levels of quality and financial resources and

Some Key Takeaways from the *Governing Banks* Training Supplement

- The board should review and provide guidance regarding the alignment of corporate strategy with risk appetite and the internal risk-management structure.
- Understanding financial statements is a core capability of directors, and those on bank boards need a strong knowledge of complex financial products, investment strategies, and valuation methods.
- Effective risk governance demands that each director be aware of the breadth of risks faced by the bank. This requires timely distribution of financial information to the board as well as capable and effective risk and audit committees.
- Organizational silos endemic to any business, including banks, prevent information sharing that is critical for forming an integrated view of the firm in making board decisions about strategy.
- Risk management and control functions should be independent of profit centers, and the chief risk officer, or equivalent, should report directly to the board of directors along the lines already advocated in the OECD *Principles of Corporate Governance*.
- Interpretation of risk analysis is fraught with many pitfalls, including the inherent limits of “stress tests,” an exaggerated confidence in statistics that rely on probability, and the use of inappropriate metrics to evaluate the data.
- The major causes of serious banking problems continue to be lax credit standards for borrowers and counterparties, ineffective portfolio risk management, and a lack of attention to changes in economic or other circumstances that lead to deterioration in credit standing of bank counterparties.
- A bank’s many stakeholders, including investors, depositors, and regulators, have diverging interests in what constitutes stability and growth. How those interests are reconciled is a demonstration of a bank’s corporate governance practices.
- A bank’s risk policies may be well-crafted, but in the end what matters most is the institution’s culture—such as the value placed on caution, thorough analysis, and transparency.
- Because banking is subject to fast-paced change, the institution’s governance approach must promote flexibility and adaptability to avoid extinction, but it also requires sufficient oversight and safeguards to minimize the bank’s vulnerability.

to keep a certain amount of capital on reserve at a central bank. As a result, bank directors need to understand the philosophy behind banking regulation and the types of common regulation, as well as best practices such as the regulations espoused by the Basel Committee on Banking Supervision.

Governing Banks includes a description of the “three pillars” of the Basel II regulation: minimum capital requirements, supervisory review, and market discipline. It also describes how banks “risk weight” assets, and it discusses the difference between microprudential regulation designed to protect the



Group exercise at the first FMRP training of trainers, Indonesia, November 2010.

health of individual banks and macroprudential, or systemic, regulation designed to protect the health of the economic system as a whole.

However, banking regulations—and the culture that gives rise to them—differ from market to market. In some markets, bank directors need no special qualifications and no training, but other markets such as Indonesia and Malaysia require bank directors to undergo mandatory training. Similarly, many national regulators must approve bank directors as “fit and proper,” but what that means, and whether it includes any financial expertise, varies greatly.

“What matters most is not the techniques used in risk measurement. It’s culture.”

Chief Risk Officer of a bank in Central Asia
(during confidential consultation in formulation of *Governing Banks*)

So, even though the core concepts of banking may be constant, implementation is strongly affected by market-specific factors. To accommodate those differences, the Financial Markets Recovery Project contextualizes the *Governing Banks* curriculum to each market through market-specific overlay materials. The work starts with a thorough survey of existing training products on the market to craft a differentiated training program to meet local demand while avoiding a duplication of existing efforts.

For example, in Indonesia our partner, Indonesian Institute for Corporate Directorship (IICD), led working groups to articulate the local context and specific country case studies that supplement the international best practice and principles covered through *Governing Banks*. One of the illustrative challenges was to adapt the curriculum to the local financial institutions’ two-tier board structure, which consists of the management board (all executive directors) and a separate

supervisory board (all non-executive directors). The dual structure imposes significant governance demands on the functional relationship between the two tiers. Having strong policies and procedures in place can bridge these difficulties. Addressing these issues with country-specific materials provides depth and content that speaks to the realities and challenges faced by Indonesian bank directors.

4. Effective project rollout should start with fostering local multistakeholder alliances.

The importance of securing appropriate strategic partnerships with local entities is paramount for the project’s impact and long-term sustainability. Therefore, the Forum started by conducting a comprehensive assessment of the market to identify potential partners and competing sector training programs and products.

In Indonesia, for example, the Forum assessed over 40 entities engaged in the delivery of training programs relevant to the banking sector. It resulted in signing a tripartite Memorandum of Understanding between the Forum, the Indonesian Institute for Corporate Directorship, and Perbanas (the bankers association). IICD will lead the training activities and content localization in Indonesia and other East Asian countries through the Institute of Directors of East Asia (IDEA.net), which it currently chairs. Perbanas is providing critical support by securing the participation of Indonesia’s financial community, including bankers, regulators, financial markets experts, and corporate governance leaders.

In Bangladesh, a comprehensive due diligence mission looking at multiple evaluation criteria led to identification of a number of potential partners, including the Bangladesh Enterprise Institute (BEI), the Bangladesh Association of Banks (BAB) and Bangladesh Institute of Capital Market (BICM). The Forum has worked with BEI in the past and together with the IFC Bangladesh Corporate Governance Project is engaging these and other partners on FMRP and related activities.

In both countries, local offices of IFC Advisory services provide crucial support to the project's activities. The training in Indonesia is supported by the Swiss Office for Economic Cooperation (SECO), and in Bangladesh — by the Government of Netherlands.

Similar due diligence and partnership strategy is being followed in Nigeria and other candidate countries.

5. Capacity development of local trainers entails long-term engagement.

Board directors, especially in the financial sector, have high standards for training programs. Providing relevant content is just a start — the training has to be professionally delivered, and preparing good trainers takes time. Therefore, training of trainers needs to go beyond one-time interventions and content distribution.

First, the Forum provides continual coaching and mentoring to trainers by seasoned and experienced “master” trainers. To effectively guide the integration of *Governing Banks* and *Board Leadership* into a partner's training curriculum, a master trainer must possess a carefully balanced combination of domain expertise, skills in providing adult education, a good sense of diplomacy, and facilitation capabilities.

Second, alumni of the ToT program are invited to join a dedicated Web-based global network where members can share their knowledge, expertise, and resources. IICD and BEI, and the program's cadre of trainers, now form part of a wider Forum community of corporate governance trainers and directors who are skilled in using and delivering the content, tools, and methodologies of the Forum's Board Leadership materials. The power of this community of peers rests on shared objectives and common challenges from the perspective of different country and regional settings.

This network provides the Forum with a reliable and growing distribution channel. Working with local partners and strengthening the formal and informal banking networks also gives FMRP the ability to stay in touch with the current needs of the banking communities, and to evolve together with their needs.

NEXT ISSUE:

Latin American Corporate Governance Institutes Network (IGCLA) has proved to be a source of important synergies for the different institutions that are currently in the process of promoting corporate governance initiatives in the region. Learn what made the network a success, and how it enriched the work programs of its members.



Master trainer Mary Jo Larson (right) leads team exercise during the first FMRP training-of-trainers workshop in Indonesia, November 2010.

FORUM TO SUPPORT A CORPORATE GOVERNANCE TRAINING CENTRE FOR BANKS IN NIGERIA



The Global Corporate Governance Forum of the International Finance Corporation (IFC) signed a Memorandum of Understanding (MOU) with FITC, a non-profit founded by the Central Bank of Nigeria and the Nigeria Deposit Insurance Corporation, to develop a training program for bank board directors in Nigeria. The MOU was signed on March 28, 2011 by Dr. Lucy Newman, FITC CEO (pictured), and

Solomon Quaynor, IFC Country Manager. The partners will produce a curriculum adapted to the Nigerian context and train Nigerian trainers on the use of the *Board Leadership Training Resources* and *Governing Banks* supplement under the Forum's Board Leadership Training of Trainers program.

