



The Advanced IRB Forum

Governance

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Today's agenda will include the following topics

- ❑ The scope of IRB Governance Issues
- ❑ CP3 Risk Governance Requirements – parts of 3
- ❑ Strategy, Principles and Policy
- ❑ Oversight & Reporting to Board & Senior Management
- ❑ Structural Requirements

The scope of IRB Governance Issues

- ❑ Only deals with risk, other matters are governed by general corporate good practice
- ❑ Concerned with responsibilities of Board of Directors and Senior Management
 - Board –sets direction of risk taking activities
 - Senior Management – manages risk within parameters and framework agreed by the Board
- ❑ Addresses the physical organisation of key functions in each institution
 - Risk management functions independent of risk originators
 - Review functions (e.g. internal audit) independent of origination and risk management
 - What control activities should not be in risk origination

CP3 Risk Governance Requirements – the parts of three

1. Strategy, Principles and Policy

- The risk management responsibilities that Board and Senior Management must discharge (directive and/or approving)
 - General Pillar 2
 - Specific Pillar 1

2. Oversight & Reporting

- The risk related information which the Board and Senior Management are expected to receive and be seen to understand

3. Structural Requirements

- The way key parts of the risk management and control infrastructure must be organised to achieve adequate separation of responsibility and effective control

Strategy, Principles and Policy – Pillar 2

Board & Senior Management Responsibilities

- ❑ Approve and review the credit risk strategy and significant credit risk policies of the bank (Principles p.3)
- ❑ Understand nature and level of risks and the relation to capital level (686)
- ❑ Ensure risk management processes are adequate for risk profile and business plan (686)
- ❑ Ensure strategic plan includes capital planning dimensions (687)
- ❑ Set risk tolerance, ensure management establishes risk framework to link risk taking to capital levels (688)
- ❑ Adopt & support strong internal controls and written policies and procedures, ensure management communicate these (688)
- ❑ Ensure management create risk assessment, monitoring and risk control systems (702)

Strategy, Principles and Policy – Pillars 1 & 3

Credit Risk

- ❑ Approve all material aspects of the rating and estimation policy and process and exceptions (400)
- ❑ Demonstrate *general* understanding of the bank's risk rating system & *detailed* comprehension of associated management reports (401)

Market Risk

- ❑ Approve trading strategy for position/instruments or portfolios (646)
- ❑ Senior Management awareness of materiality and potential impact of mark to model elements in trading book (653)

Operational Risk

- ❑ Approve the standardised approach mapping policy (annex 6)

Disclosure

- ❑ Disclosure reporting policy under pillar 3 (770)

Oversight & Reporting to Board & Senior Management Pillar 2

- ❑ Senior Management or Board should receive reports on risk profile and capital needs (701)
 - Evaluate material risk & impact on capital
 - Evaluate sensitivity and reasonableness of assumptions in capital measurement system
 - Determine capital sufficiency and future requirements
 - Adjust strategic plan based on the above
- ❑ Regular information on the status of Internal Controls (N.B. also required directly by Sarbanes Oxley for US registrants) (702)

Oversight & Reporting to Board & Senior Management Pillar 1

Credit Risk

- ❑ Senior Management should give notice to Board material changes or exceptions from established policies materially impacting the bank's rating system (400)
- ❑ Reporting should include risk profile by grade, expected and realised default and loss estimates (401)

Operational Risk

- ❑ (AMA & Standardised) operational risk exposures, and loss experience to Business Unit and Senior Management and Board (626 c)

Market Risk

- ❑ Position reporting as an integral part of risk management process (646)
- ❑ Mark to model exposure management

Structural Requirements

The Structural Requirements of firms are made clearer in CP3 Pillar 1

- ❑ Independent Credit Risk Control Function
- ❑ Independent Operational Risk management function
- ❑ Independent Risk Control for Equity Exposures
- ❑ Internal Audit
- ❑ Independent Valuations for Market Risk

Independent Credit Risk control function

- ❑ Functionally independent from personnel and management functions responsible for originating loans (403)
- ❑ Assume oversight and supervision responsibilities for any models used in the rating process, and ongoing review and alterations (403)
- ❑ Actively participate in development, selection, implementation and validation of rating models (403)
 - Testing & monitoring grades
 - Analysis of predefault and post default portfolio information
 - Procedure definition for rating application
 - Reviewing and documenting changes
 - Continually assessing criteria for fitness of purpose (i.e. predictive capability)

Independent Operational Risk management function

- ❑ Independent operational risk function (626)
- ❑ Responsible for design and implementation of operational risk framework (626)
 - Policy and procedures
 - Measurement methodology
 - Risk reporting system
- ❑ Strategies to identify, measure monitor and control/mitigate operational risk (626)



Independent Risk Control for Equity Exposures

Periodic review independent of origination required (491)

- ❑ Can be by Internal Audit, Risk Control, or external
- ❑ Review all elements of the internal modelling process, model revisions, vetting of inputs, review of results
- ❑ Review completeness, accuracy and appropriateness of model inputs
- ❑ Find and limit potential errors for known weaknesses
- ❑ Identifying unknown weaknesses

Internal Audit (1)

A number of new roles and responsibilities are allocated to IA.

Credit Risk Rating Responsibilities (405)

- Operations of credit control function
- Operation of all aspects of rating systems
- Estimation process for PD, LGD and EAD
- Adherence to regulatory minimum requirements

Operational Risk Responsibilities (can also be external audit) (626)

- Regular reviews of operational risk processes and measurement systems – both Business Unit and Operational Risk Management function levels

Internal Audit (2)

Collateral measurement system (internally calculated haircuts) (136)

- ❑ Integration of risk measures into daily risk management
- ❑ Validation of any significant change in the risk management process
- ❑ Accuracy and completeness of position data
- ❑ Verification of consistency, timeliness and reliability of data sources
- ❑ Accuracy and appropriateness of volatility assumptions

Independent Valuations for Market Risk

- ❑ Department accountable for valuation must be independent of front office AND report ultimately to a main Board Director

Issues

- ❑ Internal Audit resourcing for new technical responsibilities
- ❑ Firms making good progress towards governance of credit models – but there are different ways of doing it for different risk types
 - Highly centralised development for sovereigns and banks
 - Largely centralised development for corporate
 - Decentralised development with central standards for retail
- ❑ Capital management standards encourage a risk based approach – natural evolution to Economic Capital over time?
- ❑ Integrated risk management is not a requirement – what are the features that will get pillar 2 benefits?

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Supplemental Information



- ❑ **Principle 1: The board of directors should have responsibility for approving and periodically (at least annually) reviewing the credit risk strategy and significant credit risk policies of the bank. The strategy should reflect the bank’s tolerance for risk and the level of profitability the bank expects to achieve for incurring various credit risks.**

- ❑ **Principle 2: Senior management should have responsibility for implementing the credit risk strategy approved by the board of directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address credit risk in all of the bank’s activities and at both the individual credit and portfolio levels.**

- ❑ **Principle 3: Banks should identify and manage credit risk inherent in all products and activities. Banks should ensure that the risks of products and activities new to them are subject to adequate risk management procedures and controls before being introduced or undertaken, and approved in advance by the board of directors or its appropriate committee.**