



5 July 2013

Mr Neil Grummitt
General Manager, Policy Development
Policy, Research and Statistics
Australian Prudential Regulation Authority
GPO Box 9836
Sydney NSW 2001

Dear Neil,

Re: Harmonising cross industry risk management requirements

Please find enclosed our submission with reference to the above consultation process. Our paper titled 'Raising Risk Governance Standards for Australian Banks' contains our recommendations. This submission is prepared as part of the research project 'Elements of Risk Governance and Culture'. The project has been funded jointly by the Centre for International Finance and Regulation¹ and Macquarie University.

A second paper (to follow by 18/7/13) will provide a detailed description of the research we have undertaken to support these recommendations.. In summary, we have evaluated the regulations and standards applying to the risk governance of Australian banks as at January 2013. We have compared them to similar regulations and standards in Canada, China, the EU, Indonesia, Japan, Germany, Singapore, Switzerland, the UK and the US. Our benchmark for analysis was Basel Committee 'Principles for enhancing corporate governance' (October 2010).

This submission represents the views of Dr Shane Magee, A/Professor Elizabeth Sheedy and A/Professor Sue Wright but does not necessarily reflect the views of either funding body.

Yours sincerely,

Elizabeth Sheedy Ph.D.
Associate Professor

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Raising Risk Governance Standards for Australian Banks

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Following the banking crisis of 2008/09, a new consensus has emerged regarding the need for reform in the governance and risk management of financial institutions (see IIF (2008) for example). In many well documented cases the governance and risk management of financial institutions was found wanting and these weaknesses very likely contributed to instances of insolvency and the need for taxpayer funded support. While Australian financial institutions fared relatively well in the crisis period, the lessons learned internationally with respect to risk governance should not go unheeded in this country.

A sustainable financial system requires a combination of elements of which good prudential standards is only one. The effectiveness of the supervision process is probably just as, if not more, important. Nevertheless, clear and comprehensive standards are a vital element because they provide clarity and support for those Directors and senior executives making a genuine attempt to improve the governance of their organisations. In boardroom debates, clear principles will provide a framework for discussion and a benchmark for comparison. Without comprehensive risk governance principles there may be justification to argue that supervisors do not see risk governance as a priority.

The attached paper 'Reforming the Governance of Financial Institutions: A Progress Report' shows that (as of January 2013) Australia's risk governance standards are currently not as comprehensive as they might be. Since the crisis, a number of other countries have taken steps to upgrade their risk governance standards. The EU, Singapore and Canada are three jurisdictions where standards appear further advanced than ours in reflecting the new industry consensus regarding effective risk governance.

We therefore welcome the release of CPS 220 and CPS 510. If implemented, these new standards will go a long way towards addressing the gaps identified in our research. For example, we applaud the new requirement for an independent Chief Risk Officer (CRO) and a Board Risk Committee. We have, however, identified a number of areas where we believe that more can be done and these are highlighted below.

In preparing this submission we are aware that APRA purposely adopts a non-prescriptive regulatory style. APRA prefers to focus on principles in its prudential statements rather than giving detailed guidelines regarding the implementation of those principles. By leaving open the implementation of many standards on paper, APRA avoids a 'box-ticking' supervisory approach which can be counter-productive to effective risk management and governance. Rather, Directors are encouraged to take responsibility for ensuring that principles have been adequately addressed in the specific context of their own firm's operations. This approach has potential advantages when combined with supervisory visits that are intrusive, thorough and wide-ranging in scope. In the context of these supervisory visits, detailed investigations are made that explore how the prudential standards have been implemented. APRA's style is also supported by the socio-political environment in Australia as it receives strong support from governments of all persuasions.

While we recognise the advantages of this approach in Australia, there are also several disadvantages. Firstly there is the issue of Australia's reputation as a well-regulated financial centre in its international context. On the face of it, Australia's prudential standards are less comprehensive and this may create a false impression of the supervisory environment. Secondly, we note that Executives and Directors are, in many cases, seeking guidance as to how they can best achieve effective governance and risk management. The minimalist approach means that the opportunity to guide and educate through standard setting is lost to some extent. Prudential Practice Guides may address this need but we caution that the status of Information Sheets and Prudential Practice Guidelines may be viewed differently by different firms and by other international regulators who look to APRA for best-practice guidance, creating confusion and multiplicity of approaches.

Recommendations

i) Developing Culture

CPS 220 highlights the need for Directors to establish and maintain a sound risk management culture (at [12]). The means by which Directors should do this is not yet well understood; indeed our own research is addressing this issue. There is, however, some research to suggest that a high quality corporate Codes of Conduct can be a useful tool for reducing unwanted employee behaviour as part of a broader program for managing conduct (see Kaptein and Schwartz, 2008 and Erwin, 2011).

BCBS (2010) [27] promotes the use of a Code of Conduct (or similar policy) so that banks can articulate the standards of behaviour expected of employees with regard to appropriate risk-taking in addition to improper or illegal activity. The existence of a clear Code of Conduct creates an environment where breaches of risk policy are more easily addressed and potentially punished since all employees should be aware of their risk obligations.

We recommend that such Codes of Conduct be introduced as a requirement for financial institutions. We further recommend that evidence-based guidance be provided explaining how to maximise the usefulness of such Codes of Conduct. The above-mentioned research papers are a useful starting point. We hope to provide further input on this question of culture as our research progresses.

ii) Board Qualifications and Training

CPS 510 discusses the qualifications of Directors and senior management at [19]. We note that there is no specific mention of Director training. BCBS (2010) [37] recommends the use of induction and ongoing training programs to assist Directors to acquire, maintain and deepen their knowledge and skills. Given the complexity of risks to which financial institutions are exposed, we advocate more specific direction with regard to training programs. This could be achieved through Prudential Practice Guidance.

iii) Oversight of Senior Management

The monitoring of senior management is mentioned in CPS 510 [18] but we believe that more guidance could usefully be given as to how this may be achieved. We note that in BCBS (2010) [31] specific mention is made of performance standards consistent with long-term objectives as well as regular face-to-face meetings. This could be achieved through Prudential Practice Guidance.

iv) Reporting to the Board

CPS 220 discusses the importance of regular, accurate and timely information being provided to Directors and senior management. While all these attributes are important, we are concerned about the possibility that Directors may have difficulty interpreting risk reports or that crucial information may be buried deep in very lengthy reports. We note that BCBS (2010) [94, 96] emphasises the importance of concise and meaningful risk reports for Directors. This approach is also supported by IIF (2013) at p. 30. We recommend that additional direction should be provided in relation to risk reporting, possibly through Prudential Practice Guidance.

v) Processes for Assessing Risk of New Products and Businesses, Mergers and Acquisitions

It is apparent that acquisitions, mergers, new products and businesses create special risks and are therefore deserving of special risk management attention. See for example BCBS (2010) at [88, 89]. We were not able to find any specific discussion of this in CPS 220 and we therefore recommend that this be addressed through Prudential Practice Guidance.

vi) Status and Remuneration of Risk Managers

At several points CPS 220 highlights the need for risk managers to enjoy adequate status within the financial institution. In our experience, status is closely linked to the total quantum of remuneration over time yet risk managers are often poorly paid relative to those with similar qualifications and experience in customer facing roles. Research supports these hypotheses (Ellul and Yerramilli, forthcoming). The Financial Stability Board (2009) recommends that the remuneration of risk managers should be adequate 'to attract qualified and experienced staff'. We propose that CPS 220 specifically address this issue or that this issue be addressed through Prudential Practice Guidance.

vii) Know and Understand your Structure

CPS 220 highlights the need for the Board of an APRA-regulated institution that is Head of a group to ensure that the operational structure of the institution facilitates effective risk management (at [4], [12 (d)], [17-19]). Given the challenges of identifying and managing the risks arising from large, complex group structures (see BCBS (2010) principles 12 and 13), we recommend that APRA stresses the importance of this further, by making it explicit that the Risk management declaration in Attachment A for the Board of an APRA-regulated institution that is Head of a group is to be applied at both the group level and at the subsidiary level. We also recommend that additional guidance be provided on "knowing and understanding your structure", possibly through Prudential Practice Guidance.

References

BCBS (2010) 'Principles for enhancing corporate governance', available at www.bis.org
Directors and Chief Risk Officers Group 'Qualified Risk Director Guidelines' available at http://www.thegovernancefund.com/DCRO/PDF/Qualified_Risk_Director_Guidelines.pdf

Ellul and Yerramilli (forthcoming) 'Stronger risk controls, lower risk: Evidence from u.S. Bank holding companies', **Journal of Finance**

Erwin, P., 2011, 'Corporate Codes of Conduct: The Effects of Code Content and Quality on Ethical Performance' **Journal of Business Ethics** 99(4) 535-548

Financial Stability Board (2009) 'Principles for Sound Compensation Practices'

Institute of International Finance, 2008, Final report of the IIF committee on market best practices: Principles of conduct and best practice recommendations. www.iif.com

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Kaptein, M and M. Schwartz, 2008, 'The Effectiveness of Business Codes: A Critical Examination of Existing Studies and the Development of an Integrated Research Model', **Journal of Business Ethics** 77:111-127