
Credit Skills Library

Basel II

**A review summary of the challenges
facing financial institutions**

Chartered Banker

Leading financial professionalism

Published by
The Chartered Institute of Bankers in Scotland
Drumsheugh House
38b Drumsheugh Gardens
Edinburgh EH3 7SW

Senior authors: Keith Checkley FCIB, FCIBS and Keith Dickinson FCIB

Editing and layout by Keystone Business Associates, Glasgow

The authors have taken all reasonable measures to ensure the accuracy of the information contained in this topic and cannot accept responsibility or liability for errors or omissions from any information given or for any consequences arising.

© Keith Checkley & Associates, March 2009

No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means - electronic, electrostatic, magnetic tape, mechanical, photocopying, recording or otherwise, without permission in writing from The Chartered Institute of Bankers in Scotland.

Basel II

Key learning outcomes	5
International Convergence of Capital Measurement and Capital Standards: a Revised Framework	6
The Report	6
A comparison between Basel I and II	9
The First Pillar – Choices in calculation	10
The Second Pillar – Supervisory process	10
Importance of the supervisory review	11
Four key principles of supervisory review	12
The Third Pillar – Market discipline	12
Disclosure requirements	12
Guiding principles	12
Disclosure requirements	13
A precis of disclosure requirements	14
Scope of Application – Table 1	14
Capital Structure – Table 2	14
Capital Adequacy – Table 3	14
Credit Risk: General Disclosures for all Banks – Table 4	14
Credit Risk: Disclosures for Portfolios subject to the Standardised Approach and Supervisory Risk Weights in the IRB Approaches – Table 5	15
Credit Risk: Disclosures for Portfolio Subject to IRB Approaches – Table 6	15
Credit Risk Mitigation: Disclosure for Standardised and IRB Approaches – Table 7	16
Securitisation: Disclosure for Standardised and IRB Approaches – Table 8	16
Market Risk: Disclosures for Banks using the Standardised Approach – Table 9	16
Market Risk: Disclosures for Banks using the Internal Models Approach (IMA) for Trading Portfolios – Table 10	17
Operational Risk – Table 11	17
Equities: Disclosures for Banking Book Positions – Table 12	17
Interest Rate Risk in the Banking Book – Table 13	17
Basel II Summary – The Three Pillars	18
Appendix 1: Basel II – Credit Risk: Standard Approach	19
Appendix 2: Treatment of Corporate Claims	20
Appendix 3: Operational Risk – Basel II Definition	22
Appendix 4: Guidance related to the Supervisory Review Process	23
Appendix 5: Abbreviations	24
Review	25

Welcome to the Credit Skills Library.

There have been previous financial crises but this time it is the severity and global impacts that are very different from what we have seen before. Never have banks and lending bankers received greater criticism over the quality of their lending than at the present time.

Media comment suggests that prudent lending principles have been disregarded in the quest in recent years for increased lending volumes and enhanced short term profitability. Analysts suggest that many of the prudential canons of lending have been overlooked and many lending bankers would benefit from a reconsideration and review of well tested and accredited lending principles. It is against this background that the Credit Skills Library has been developed.

The modules in this Library have been prepared to allow you and your colleagues instant access via e-learning and may be accessed as individual topics in which you are interested. We believe that they will also make an excellent basis for discussion with colleagues for mutual benefit.

We do hope that the extensive range will help you in your everyday job and also as someone interested in self development in the important area of Credit Skills.

Keith Checkley FCIBS and Keith Dickinson FCIB
Senior authors

Working with The Chartered Institute of Bankers In Scotland

Basel II

Key learning outcomes

- The purpose and intentions of the revised framework for International Convergence of Capital Measurement and Capital Standards (Basel II).
 - The content and objectives of the 3 Pillars: Capital Requirements, Regulatory Review, Market Discipline.
 - Assessment and calculation of credit risk, market risk, operational risk.
 - Significance of the supervisory review process.
 - Principles and extent of disclosure requirements.
-

International Convergence of Capital Measurement and Capital Standards: a Revised Framework

An extract from press statement – 26 June 2004

“Central bank governors and the heads of bank supervisory authorities in the Group of Ten (G10) countries issued a press release and endorsed the publication of *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, the new capital adequacy framework commonly known as Basel II. The governors and supervisors met at the Bank for International Settlements in Basel, Switzerland, to review the text prepared by the Basel Committee on Banking Supervision.”

The Report

The Basel II Report of June 2004 presents the outcome of the Basel Committee on Banking Supervision’s (“the Committee”) work over recent years to secure international convergence on revisions to supervisory regulations governing the capital adequacy of internationally active banks.

Following publication of the Committee’s first round of proposals for revising the capital adequacy framework in June 1999, an extensive consultative process was set in train in all member countries and the proposals were also circulated to supervisory authorities worldwide. The Committee subsequently released additional proposals for consultation in January 2001 and April 2003. It also conducted three quantitative impact studies relating to its proposals. As a result, many valuable improvements have been made to the original proposals.

The present paper is a statement of the Committee agreed by all its members. It sets out the details of the agreed framework for measuring capital adequacy and the minimum standard to be achieved which the national supervisory authorities represented on the Committee will propose for adoption in their respective framework countries. This framework, and the standard it contains, have been endorsed by the Central Bank Governors and the Heads of Banking Supervision of the Group of Ten Countries. (ref: www.bis.org/publ/bcbsca.htm)

The framework was to be available for implementation as of year end 2006. The Committee, however, felt that one further year of impact studies or parallel calculations would be needed for the most advanced approaches, and therefore these were available for implementation as of year end 2007.

The document was circulated to supervisory authorities worldwide, with a view to encouraging them to consider adopting the revised framework at such time as they believed it to be consistent with their broader supervisory priorities. Each national supervisor was to consider carefully the benefits of the revised framework in the context of its domestic banking system when developing a timetable and approach to implementation.

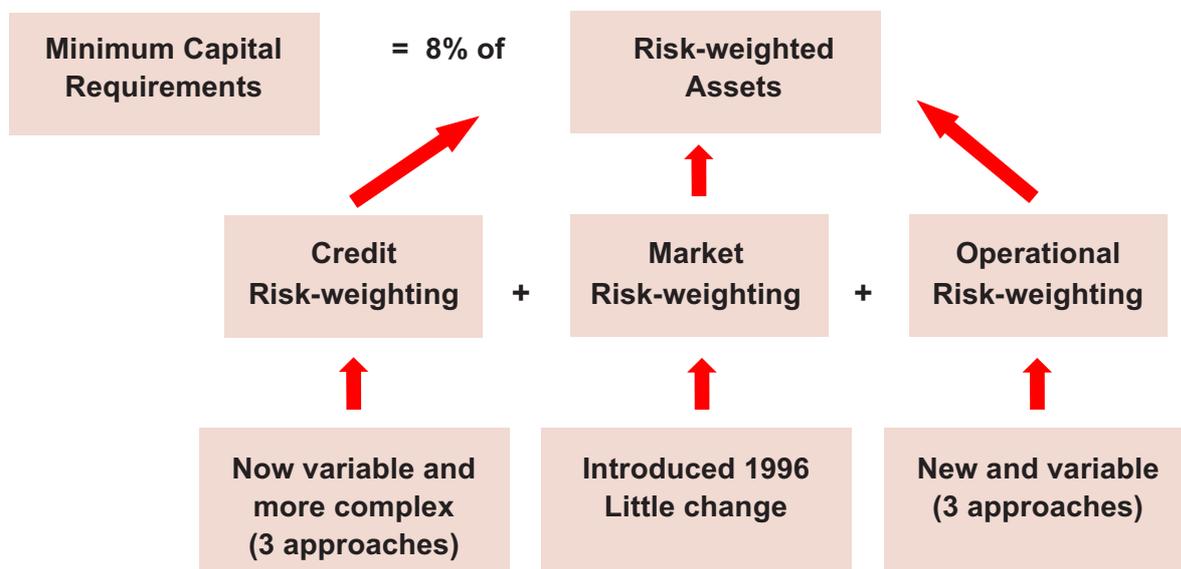
The fundamental objective of the Committee’s work to revise the 1988 Accord has been to develop a framework that would further strengthen the soundness and stability of the international banking system while also maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks.

The Committee believes that the framework will promote the adoption of stronger risk management practices by the banking industry and views this as one of its major benefits. The Committee notes that, in their comments on the proposals, banks and other interested parties have welcomed the concept and rationale of the three pillars approach – minimum capital requirements, supervisory review and market discipline – on which the revised framework is based.

In developing the revised framework, the Committee also retained key elements of the 1988 capital adequacy framework, including:

- the general requirement for banks to hold total capital equivalent to at least 8% of their risk-weighted assets
- the basic structure of the 1996 Market Risk Amendment regarding the treatment of market risk
- the definition of eligible capital.

A significant innovation of the revised framework is the greater use of the assessments of risk provided by the banks' internal systems as inputs to capital calculations. In taking this step, the Committee was also putting forward a detailed set of minimum requirements designed to ensure the integrity of these internal risk assessments. It was not the Committee's intention to dictate the form or operational detail of a bank's risk management policies and practices. Each supervisor was to develop a set of review procedures for ensuring that the bank's systems and controls are adequate to serve as the basis for the capital calculations. Supervisors will need to exercise sound judgements when determining a bank's state of readiness, particularly during the implementation process. The Committee expects national supervisors will focus on compliance with the minimum requirements as a means of ensuring the overall integrity of a bank's ability to provide prudential inputs to the capital calculations and not as an end itself.



The revised framework provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and supervisors to select approaches that are most appropriate for their operations and their financial market infrastructure. In addition, the framework allows for a limited degree of national discretion in the way in which each of these options may be applied to adapt the standards to different conditions of national markets. These features, however, will necessitate substantial efforts by national authorities to ensure sufficient consistency in application.

The Committee also recognised that home country supervisors have an important role in leading the enhanced cooperation between home and host country supervisors that will be required for effective implementation.

It should be stressed that the revised framework is designed to establish minimum levels of capital for internationally active banks. As under the 1988 Accord, national authorities are free to adopt arrangements that set higher levels of minimum capital. Moreover, they are free to put in place supplementary measures of capital adequacy for the banking organisations they charter. National authorities may use a supplementary capital measure as a way to address, for example, the potential uncertainties in the accuracy of the measure of risk exposures inherent in any capital rule or to constrain the extent to which an organisation may fund itself with debt. Where a jurisdiction employs a supplementary capital measure (such as a leverage ratio or a large exposure limit) in conjunction with the measure set forth in this framework, in some instances the capital required under the supplementary measure may be more binding. More generally, under the second pillar, supervisors should expect banks to operate above minimum regulatory capital levels.

The revised framework is more risk sensitive than the 1988 Accord, but countries where risks in the local banking market are relatively high, nonetheless need to consider if banks should be required to hold additional capital over and above the Basel minimum. This is particularly the case with the more broad brush standardised approach, but, even in the case of the internal ratings-based (IRB) approach, the risk of major loss events may be higher than allowed for in this framework.

The Committee also wishes to highlight the need for banks and supervisors to give appropriate attention to the second (supervisory review) and third (market discipline) pillars of the revised framework. It is critical that the minimum capital requirements of the first pillar be accompanied by a robust implementation of the second, including efforts by banks to assess their capital adequacy and by supervisors to review such assessments. In addition, the disclosures provided under the third pillar will be essential in ensuring that market discipline is an effective complement to the other two pillars.

The Committee is aware that interactions between regulatory and accounting approaches at both national and international level can have significant consequences for the comparability of the resulting measures of capital adequacy and for the costs associated with the implementation of these approaches. The Committee believes that its decisions with respect to unexpected and expected losses represent a major step forward in this regard. The Committee and its members intend to continue playing a proactive role in the dialogue with accounting authorities in an effort to reduce, wherever possible, inappropriate disparities between regulatory and accounting standards.

The revised framework reflects several significant changes relative to the Committee's consultative proposal in April 2003. A number of these changes was described in the Committee's press statements of October 2003, January 2004 and May 2004. These include the changes in the approach to the treatment of expected losses (EL) and unexpected losses (UL) and to the treatment of securitisation exposures. In addition to these, changes in the treatments of credit risk mitigation and qualifying revolving retail exposures, among others, have also been incorporated. The Committee has also sought to clarify its expectations regarding the need for banks using the advanced IRB approach to incorporate the effects arising from economic downturns into their loss-given-default (LGD) parameters.

The Committee believes it is important to reiterate its objectives regarding the overall level of minimum capital requirements which are to broadly maintain the aggregate level of such requirements, while also providing incentives to adopt the more advanced risk-sensitive approaches of the revised framework.

The Committee has designed the revised framework to be a more forward-looking approach to capital adequacy supervision, one that has the capacity to evolve with time which is necessary to ensure that the framework keeps pace with market developments and advances in risk management practices.

The Committee also seeks to continue to engage the banking industry in a discussion of prevailing risk management practices, including those practices aiming to produce quantified measures of risk and economic capital. Over the last decade, a number of banking organisations have invested resources in modelling the credit risk arising from their significant business operations. Such models are intended to assist banks in quantifying, aggregating and managing credit risk across geographic and product lines. While the framework stops short of allowing the results of such credit risk models to be used for regulatory capital purposes, the Committee recognises the importance of continuing active dialogue regarding both the performance of such models and their comparability across banks.

Moreover, the Committee believes that a successful implementation of the revised framework will provide banks and supervisors with the critical experience necessary to address such challenges. The Committee understands that the IRB approach represents a point on the continuum between purely regulatory measures of credit risk and an approach that builds more fully on internal credit risk models.

In principle, further movements along that continuum are foreseeable, subject to an ability to address adequately concerns about reliability, comparability, validation and competitive equity. In the meantime, the Committee believes that additional attention to the results of internal credit risk models in the supervisory review process and in banks' disclosures will be highly beneficial for the accumulation of information on the relevant issues.

A comparison between Basel I and II

Basel I	Basel II
Focus on a single risk measure	More emphasis on banks' own internal methodologies, supervisory review, and market discipline
One size fits all	Flexibility, menu of approaches, incentives for better risk management
Broad brush structure	More risk sensitivity
Capital Calculation $\text{Capital Ratio} = \frac{\text{Total Capital}}{\text{Credit Risk}}$ (RWA banking book)	$\text{Capital Ratio} = \frac{\text{Total Capital}}{\text{Credit Risk} + \text{Market Risk} + \text{Operational Risk}}$ (Trading book)

The First Pillar – Choices in calculation

	Basic	Intermediate	Advanced
Credit Risk	'Standardised' Successor to the 1988 Accord with some additional sensitivities	'Foundation' – internal rating based approach Portfolio split by category of exposure – input from institution and regulator	'Advanced' – internal rating-based approach As for Foundation but all parameters calculated by institution.
Market Risk	No major change in current approach		
Operational Risk*	'Basic Indicator Approach' Capital charge based on single risk indicator	'Standardised Approach' Capital charge based on sum of 8 Business Line risk indicators, each calculated by defined industry standards	'Advanced Measurement Approach' Capital charge by Business Line, internally calculated and variable on level of risk

* Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

The Second Pillar – Supervisory process

The second pillar has two objectives:

- compliance with the higher approaches to capital calculations
- sound integrated risk management systems and controls.

All regulated organisations must develop:

- an appropriate risk management environment
- risk identification, assessment, monitoring and mitigation/control
- regular independent evaluation of policies, procedures and practices
- make sufficient public disclosure to allow the market to assess their approach to operational risk management.

The basic approaches to capital adequacy calculation do not exclude new requirements:

- a risk assessment culture must be created
- credit and operational risks must be monitored

- risk events must be recorded
- a risk data base must be created
- risk actions must be disclosed.

All financial institutes will need a coordinated programme:



Importance of the supervisory review

The supervisory review process of the framework is intended not only to ensure that banks have adequate capital to support all the risk in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks.

The supervisory review process recognises the responsibility of bank management in developing an internal capital assessment process and setting capital targets that are commensurate with the bank's risk profile and control environment.

In the framework, bank management continues to bear responsibility for ensuring that the bank has adequate capital to support its risks beyond the core minimum requirements.

Supervisors are expected to evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate. This interaction is intended to foster an active dialogue between banks and supervisors, such that when deficiencies are identified, prompt and decisive action can be taken to reduce risk or restore capital. Accordingly supervisors may wish to adopt an approach to focus more intensely on those banks with risk profiles or operational experience that warrants such attention.

The Committee recognises the relationship that exists between the amount of capital held by the bank against its risks and the strength and effectiveness of the bank's risk management and internal control processes.

Increased capital should not be viewed as the only option for addressing increased risks confronting the bank. Other means for addressing risk, such as strengthening risk management, applying internal limits, strengthening the level of provisions and reserves and improving internal controls, must also be considered. Furthermore, capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management processes.

Particular focus can be directed towards risks that are not fully captured by the Pillar 1 process (such as credit concentration risk), those factors not taken into account by the Pillar 1 process (such as interest rate risk in the banking book, business and strategic risk) and factors external to the bank (such as business cycle effects).

The assessment of compliance is also vital, with the minimum standards and disclosure requirements of the more advanced methods in Pillar 1, in particular the IRB framework for credit risk and the Advanced Measurement Approaches for operational risk.

Four key principles of supervisory review

- Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.
- Principle 2: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.
- Principle 3: Supervisors should expect banks to operate above the minimum capital ratios and should have the ability to require banks to hold capital in excess of the minimum.
- Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

The Third Pillar – Market discipline

Disclosure requirements

The Committee believes that the rationale for Pillar 3 is sufficiently strong to warrant the introduction of disclosure requirements for banks using the framework. Supervisors have an array of measures that they can use to require banks to make such disclosures. Some of these disclosures will be qualifying criteria for the use of particular methodologies or the recognition of particular instruments and transactions.

Guiding principles

The purpose of Pillar 3 – market discipline – is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2).

The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution.

The Committee believes that such disclosures have particular relevance under the framework, where reliance on internal methodologies gives banks more discretion in assessing capital requirements.

In principle, banks disclosures should be consistent with how senior management and the board of directors assess and manage the risks of the bank. Under Pillar 1, banks use specified approaches/methodologies for measuring the various risks they face and the resulting capital requirements. The Committee believes that providing disclosures that are based on this common framework is an effective means of informing the market about a bank's exposure to those risks and provides a consistent and understandable disclosure framework that enhances comparability.

Disclosure requirements

■ General disclosure principle

The Committee is aware that supervisors have different powers available to them to achieve the disclosure requirements. Market discipline can contribute to a safe and sound banking environment, and supervisors require firms to operate in a safe and sound manner. Under safety and soundness grounds, supervisors could require banks to disclose information. Alternatively, supervisors have the authority to require banks to provide information in regulatory report which could be made publicly available.

A number of mechanisms exist by which supervisors may enforce requirements. These vary from country to country and range from moral suasion through dialogue with the bank's management, to reprimands or financial penalties. The nature of the exact measures used will depend on the legal powers of the supervisor and the seriousness of the disclosure deficiency.

The Committee recognises the need for a Pillar 3 disclosure framework, covering bank capital adequacy, that does not conflict with requirements under accounting standards, which are broader in scope. The Committee intends to maintain an ongoing relationship with accounting authorities and will consider future modifications for the disclosures required in Pillar 3.

Banks should have a formal disclosure policy approved by the board of directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process.

In addition, banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency.

Banks should explain material differences between the accounting or other disclosure and the supervisory basis of disclosure.

For disclosures that are not mandatory under accounting or other requirements, management may choose to provide Pillar 3 information through other means consistent with requirements of national supervisory authorities. Institutions are encouraged to provide all related information in one location.

A bank should decide which disclosures are relevant based on the materiality concept. Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions. This definition is consistent with International Accounting Standards and with many national accounting frameworks. The Committee recognises the need for qualitative judgement of whether a user of financial information would consider the item to be material (user test). Specific thresholds for disclosure have not been set as these can be open to manipulation and are difficult to determine. It is believed that the user test is a useful benchmark for achieving sufficient disclosure.

A precis of disclosure requirements

Scope of Application – Table 1	
Qualitative Disclosures	The name of the top corporate entity in the group, to which the framework applies.
Quantitative Disclosures	<ul style="list-style-type: none"> • The aggregate amount of surplus capital of insurance subsidiaries (whether deducted or subjected to an alternative method) included in the capital of the consolidated group. • The aggregate amount of capital deficiencies in all subsidiaries not included in the consolidation. • The aggregate amounts (eg current book value) of the firm's total interests in insurance entities which are risk weighted.
Capital Structure – Table 2	
Qualitative Disclosures	Summary information on the terms and conditions of the main features of all capital instruments, especially in the case of innovative, complex or hybrid capital instruments.
Quantitative Disclosures	<ul style="list-style-type: none"> • The amount of Tier 1 capital, with separate disclosure of make-up • The total amount of Tier 2 and Tier 3 capital • Other deductions from capital • Total eligible capital
Capital Adequacy – Table 3	
Qualitative Disclosures	A summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities.
Quantitative Disclosures	<ul style="list-style-type: none"> • Capital requirements for credit risk and make-up • Capital requirements for equity exposures in the IRB approach • Capital requirements for market risk • Capital requirements for operational risk • Total and Tier 1 capital ratio
Credit Risk: General Disclosures for all Banks – Table 4	
Qualitative Disclosures	The general qualitative disclosure requirement with respect to credit risk.
Quantitative Disclosures	<ul style="list-style-type: none"> • Total gross credit risk exposures, broken down by major types of credit exposure. • Geographic distribution of exposures, broken down in significant areas by major types of credit exposure.

Credit Risk: Disclosures for Portfolios subject to the Standardised Approach and Supervisory Risk Weights in the IRB Approaches – Table 5

Qualitative Disclosures	<p>For portfolios under the standardised approach:</p> <ul style="list-style-type: none"> Names of ECAs and ECAs used Types of exposure for which agency is used The alignment of the alphanumeric scale of each agency used with risk buckets.
Quantitative Disclosures	<ul style="list-style-type: none"> For exposure amounts after risk mitigation subject to the standardised approach, amount of a bank's outstandings (rated and unrated) in each risk bucket as well as those that are deducted For exposures subject to the supervisory risk weights in IRB, the aggregate amount of a bank's outstandings in each risk bucket.

Credit Risk: Disclosures for Portfolio Subject to IRB Approaches – Table 6

Qualitative Disclosures	<p>Supervisor's acceptance of approach/supervisory approved transition</p> <p>Explanation and review of the:</p> <ul style="list-style-type: none"> Structure of internal rating systems and relation between internal and external ratings. Use of internal estimates other than for IRB capital purposes Control mechanisms for the rating system <p>Description of the internal ratings process, provided separately for five distinct portfolios:</p> <ul style="list-style-type: none"> Corporate (including SMEs, specialised lending and purchased corporate receivables), sovereign and bank Equities Residential mortgages Qualifying revolving retail Other retail
Quantitative Disclosures for Risk Assessment	<p>For each portfolio except retail, present the following information across a sufficient number of PD grades (including default) to allow for a meaningful differentiation of credit risk:</p> <ul style="list-style-type: none"> Total exposures (for corporate, sovereign and bank, outstanding loans and EAD on undrawn commitments) For banks on the IRB advanced approach, exposure-weighted average LGD (percentage) Exposure weighted-average risk-weight For banks on the IRB advanced approach, amount of undrawn commitments and exposure-weighted average EAD for each portfolio.
Historical Results	<p>Actual losses (eg charge-offs and specific provisions) in the preceding period for each portfolio and how this differs from past experience.</p>

Credit Risk Mitigation: Disclosure for Standardised and IRB Approaches - Table 7

Qualitative Disclosures	<p>The general qualitative disclosure requirement with respect to credit risk mitigation including:</p> <ul style="list-style-type: none"> • Policies and processes for, and an indication of the extent to which the bank makes use of, on and off balance sheet netting • Policies and processes for collateral valuation and management • A description of the main types of collateral taken by the bank • The main types of guarantor/credit derivative counterparty and their creditworthiness • Information about (market or credit) risk concentrations within the mitigation taken.
Quantitative Disclosures	<p>For each separately disclosed credit risk portfolio under the standardised and/or foundation IRB approach, the total exposure (after, where applicable, on or off balance sheet netting) that is covered by:</p> <ul style="list-style-type: none"> • Eligible financial collateral • Other eligible IRB collateral after the application of haircuts.

Securitisation: Disclosure for Standardised and IRB Approaches – Table 8

Qualitative Disclosures	<p>The general qualitative disclosure requirement with respect to securitisation, including a discussion of:</p> <ul style="list-style-type: none"> • The bank's objectives in relation to securitisation activity, including the extent to which these activities transfer credit risk of the underlying securitised exposures away from the bank to the other entities • The roles played by the bank in the securitisation process and an indication of the extent of the bank's involvement in each of them.
Quantitative Disclosures	<p>The total outstanding exposures securitised by the bank and subject to the securitisation framework, by exposure type.</p>

Market Risk: Disclosures for Banks using the Standardised Approach - Table 9

Qualitative Disclosures	<p>The general qualitative disclosure requirement for market risk, including the portfolios covered by the standardised approach.</p>
Quantitative Disclosures	<p>The capital requirements for:</p> <ul style="list-style-type: none"> • Interest rate risk • Equity position risk • Foreign exchange risk • Commodity risk.

Market Risk: Disclosures for Banks using the Internal Models Approach (IMA) for Trading Portfolios – Table 10

Qualitative Disclosures	<p>The general qualitative disclosure requirement for market risk, including the portfolios covered by the IMA. For each portfolio, covered by the IMA:</p> <ul style="list-style-type: none"> • The characteristics of the models used • A description of stress testing applied to the portfolio • A description of the approach used for backtesting/validation of the accuracy and consistency of the internal models and modelling processes.
Quantitative Disclosures	<p>For trading portfolios under the IMA:</p> <ul style="list-style-type: none"> • The high, mean and low VaR values over the reporting period and period end • A comparison of VaR estimates with actual gains/losses experienced by the bank.

Operational Risk – Table 11

Qualitative Disclosures	<p>In addition to the general qualitative disclosure requirement, the approach(es) for operational risk capital assessment for which the bank qualifies.</p> <p>Description of the AMA, if used by the bank, including a discussion of relevant internal and external factors considered in the bank's measurement approach. In the case of partial use, the scope and coverage of the different approaches used.</p> <p>For banks using the AMA, a description of the use of insurance for the purpose of mitigating operational risk.</p>
-------------------------	---

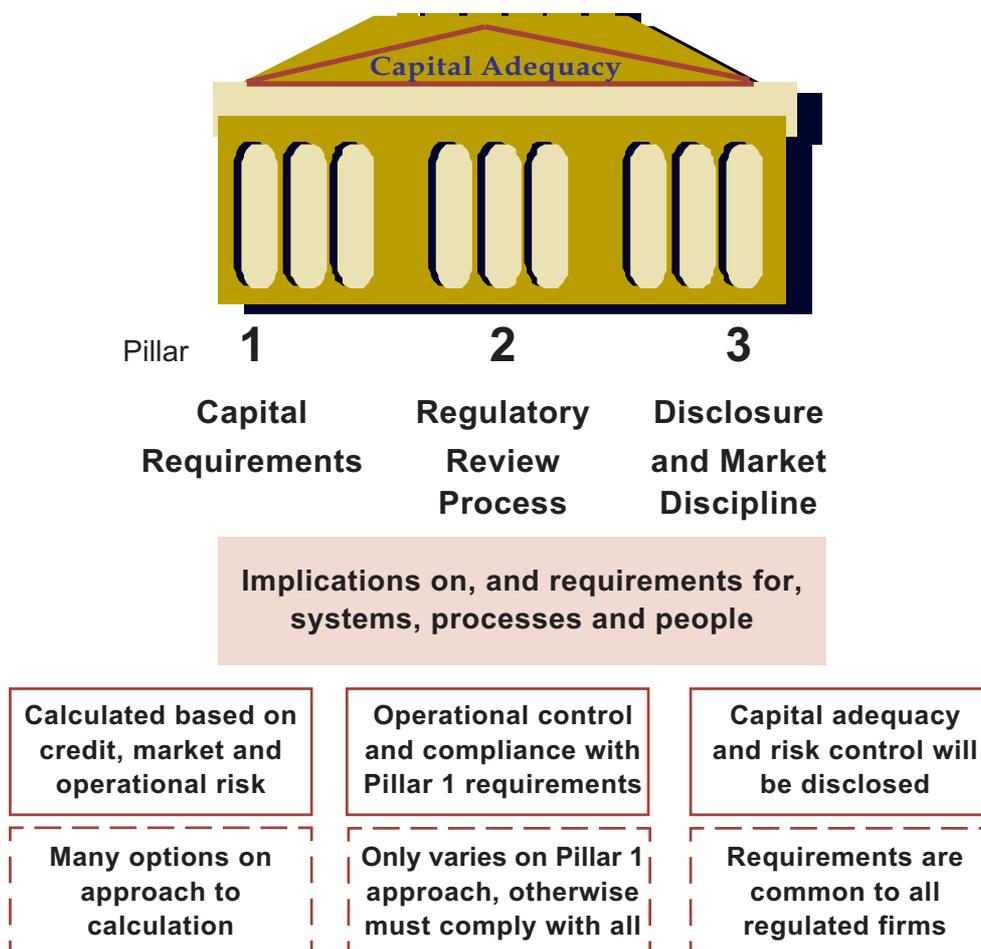
Equities: Disclosures for Banking Book Positions – Table 12

Qualitative Disclosures	<p>The general qualitative disclosure requirement with respect to equity risk, including:</p> <ul style="list-style-type: none"> • Differentiation between holdings on which capital gains are expected and those taken under other objectives including for relationship and strategic reasons • Discussion of important policies covering the valuation and accounting of equity holdings in the banking book.
Quantitative Disclosures	<p>Value disclosed in the balance sheet of investments, as well as the fair value of those investments; for quoted securities, a comparison to publicly quoted share values, where the share price is materially different from fair value.</p>

Interest Rate Risk in the Banking Book – Table 13

Qualitative Disclosures	<p>The general qualitative disclosure requirement, including the nature of the IRB and key assumptions, including assumptions regarding loan prepayments and behaviour of non-maturity deposits, and frequency of IRB measurement.</p>
Quantitative Disclosures	<p>The increase (decline) in earnings or economic value (or relevant measure used by management) for upward and downward rate shocks according to management's method for measuring IRB, broken down by currency (as relevant).</p>

Basel II Summary - The Three Pillars



Appendix 2

Example

Treatment of Corporate Claims

Credit Rating	AAA to AA-	A+ to A-	BBB+ to BB-	<BB-	Unrated
Basel I Risk Weight	100%	100%	100%	100%	100%
Basel II Risk Weight	20%	50%	100%	150%	100%

Observations: Standardised approach

Many banks are likely to follow the standardised approach, at least initially due to balance between risk sensitivity and complexity. Some banks may move toward IRB due to limitations of the standardised approach. IRB reflects emerging best practices.

Credit risk: IRB approach

Primary goal is to use banks' internal assessment of borrower risk to:

- align capital with underlying risks
- enhance risk management system.

Exposure classifications:

- Wholesale: Corporates, Banks, Sovereigns
- Retail
- Equity

Credit risk components:

Probability of Default (PD) – Likelihood of a default, expressed as a %

Loss Given Default (LGD) – Magnitude of loss, expressed as a %

Exposure at Default (EAD) – Bank's exposure amount in dollar terms

Maturity (M)

Credit Risk: IRB Advanced vs Foundation

	Foundation	Advanced
Rating	Bank	Bank
Probability of Default (PD)	Bank	Bank
Loss Given Default (LGD)	Standard supervisory estimates	Bank
Exposure at Default (EAD)	Standard supervisory estimates	Bank
Maturity (M)	Standard supervisory estimates	Bank

IRB – Challenges

- Rating system design
- Data requirements – data warehouse/upfront costs
- Corporate governance – good control mechanisms to ensure ratings integrity
- Costs/Benefits

Example (provided by BIS)

Minimum capital for \$100 commercial loan	AAA Credit risk	BBB- Credit risk	B Credit risk
Basel I	\$8	\$8	\$8
Basel II Standardised	\$1.81	\$8.21	\$12.21
Basel II Advanced IRB (LGD = 10%)	\$0.37	\$1.01	\$3.97

Appendix 3

Operational Risk – Basel II Definition

Definition

The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events – includes legal risks but excludes reputational and strategic risks.

Operational risk: examples

- Fraud – insider trading, misappropriation of assets
- Natural disasters – earthquake, terrorism
- System related failures – power down, technical breakdowns

Operational risk: advantages

- Basel I covers in terms of credit risk
- Potential operational risks significant and rising (Toronto blackout)
- Pillar 1 requirement, operation risk has been a major contributor to depletion of capital and failure of banks
- The work on operational risk is in a developmental stage
- Operational risk should be an important component of firm-wide risk

Operation risk: capital requirement

Basic Indicator Approach	15% of gross income
Standardised Approach	Different percentages (12-18%) applied to eight different business segments
Advanced Measurement Approach (AMA)	Generated by bank's own operational risk measurement systems (subject to satisfying minimum supervisory standards)

Appendix 4

Guidance related to the Supervisory Review Process

(Published by the Basel Committee on Banking Supervision)

1	Part B of the Amendment to the Capital Accord to Incorporate Market Risks	January 1996, Final
2	Core Principles for Effective Banking Supervision	September 1997, Final
3	The Core Principles Methodology	October 1999, Final
4	Risk Management Guidelines for Derivatives	July 1994, Final
5	Management of Interest Rate Risk	September 1997, Final
6	Risk Management for Electronic Banking	March 1998, Final
7	Framework for Internal Controls	September 1998, Final
8	Sound Practices for Banks' Interactions with Highly Leveraged Institutions	January 1999, Final
9	Enhancing Corporate Governance	August 1999, Final
10	Sound Practices for Managing Liquidity	February 2000, Final
11	Principles for the Management of Credit Risk	September 2000, Final
12	Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions	September 2000, Final
13	Principles for the Management and Supervision of Interest Rate Risk	January 2001, For Comment
14	Risk Management Principles for Electronic Banking	May 2001, For Comment
15	Internal Audit in Banks and the Supervisor's Relationship with Auditors	August 2001, Final
16	Customer Due Diligence for Banks	October 2001, Final
17	The Relationship between Banking Supervisors and Banks' External Auditors	January 2002, Final
18	Supervisory Guidance for Dealing with Weak Banks	March 2002, Final
19	Management and Supervision of Cross-border Electronic Banking Activities	October 2002, For Comment
20	Sound Practices for the Management and Supervision of Operational Risk	February 2003, Final

Note: The papers are available from the BIS website [www.bis.org/bcbs/publ/index.htm]

Appendix 5

Abbreviations

ABCP	Asset-backed commercial paper
ADC	Acquisition, development and construction
AMA	Advanced measurement approaches
ASA	Alternative standardised approach
CCF	Credit conversion factor
CDR	Cumulative default rate
CF	Commodities finance
CRM	Credit risk mitigation
EAD	Exposure of default
ECA	Export Credit Agency
ECAI	External credit assessment institution
EL	Expected loss
FMI	Future margin income
HVCRE	High volatility commercial real estate
IAA	Internal assessment approach
IPRE	Income-producing real estate
I/O	Interest-only strips
IRB approach	Internal ratings-based approach
LGD	Loss given default
M	Effective maturity
MDB	Multilateral development bank
NIF	Note issuance facility
OF	Object finance
PD	Probability of default
PF	Project finance
PSE	Public sector entity
QRRE	Qualifying revolving retail exposures
RBA	Ratings-based approach
RUF	Revolving underwriting facility
SF	Supervisory formula
SL	Specialised lending
SME	Small and medium sized facility
SPE	Special purpose entity
UCITS	Undertakings for collective investments in transferable securities
UL	Unexpected loss

Basel II

Review

The main points introduced here are:

- “International Convergence of Capital Measurement and Capital Standards: a Revised Framework” is a statement of the Basel Committee on Banking Supervision agreed by all its members, setting out the details of the agreed framework for measuring capital adequacy and the minimum standard to be achieved in the framework countries.
 - A significant innovation of the revised framework is the greater use of the assessments of risk provided by the banks’ internal systems as inputs to capital calculations.
 - The revised framework (Basel II) provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and supervisors to select approaches that are most appropriate for their operations and their financial market infrastructure.
 - There are 3 Pillars:
 - 1 Capital Requirements
 - 2 Regulatory Review Process
 - 3 Disclosure and Market Discipline
 - Pillar 1 provides for choices in calculation of credit risk, market risk and operational risk.
 - Pillar 2 has two objectives: compliance with the higher approaches to capital calculations and sound integrated risk management systems and controls.
 - Pillar 3 concentrates on market discipline through a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes and capital adequacy.
-

Credit Skills Library

This is one in a series of topics about credit, designed for easy access by banking professionals with a special interest in this field

Further information on the Credit Skills Library:
www.ciobs.org.uk



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Press release

Press enquiries: +41 61 280 8188
press@bis.org
www.bis.org

Ref no: 35/2010

12 September 2010

Group of Governors and Heads of Supervision announces higher global minimum capital standards

At its 12 September 2010 meeting, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, announced a substantial strengthening of existing capital requirements and fully endorsed the [agreements it reached on 26 July 2010](#). These capital reforms, together with the introduction of a global liquidity standard, deliver on the core of the global financial reform agenda and will be presented to the Seoul G20 Leaders summit in November.

The Committee's package of reforms will increase the minimum common equity requirement from 2% to 4.5%. In addition, banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%. This reinforces the stronger definition of capital agreed by Governors and Heads of Supervision in July and the higher capital requirements for trading, derivative and securitisation activities to be introduced at the end of 2011.

Mr Jean-Claude Trichet, President of the European Central Bank and Chairman of the Group of Governors and Heads of Supervision, said that "the agreements reached today are a fundamental strengthening of global capital standards." He added that "their contribution to long term financial stability and growth will be substantial. The transition arrangements will enable banks to meet the new standards while supporting the economic recovery." Mr Nout Wellink, Chairman of the Basel Committee on Banking Supervision and President of the Netherlands Bank, added that "the combination of a much stronger definition of capital, higher minimum requirements and the introduction of new capital buffers will ensure that banks are better able to withstand periods of economic and financial stress, therefore supporting economic growth."

Increased capital requirements

Under the agreements reached today, the minimum requirement for common equity, the highest form of loss absorbing capital, will be raised from the current



2% level, before the application of regulatory adjustments, to 4.5% after the application of stricter adjustments. This will be phased in by 1 January 2015. The Tier 1 capital requirement, which includes common equity and other qualifying financial instruments based on stricter criteria, will increase from 4% to 6% over the same period. (Annex 1 summarises the new capital requirements.)

The Group of Governors and Heads of Supervision also agreed that the capital conservation buffer above the regulatory minimum requirement be calibrated at 2.5% and be met with common equity, after the application of deductions. The purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks are allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distributions. This framework will reinforce the objective of sound supervision and bank governance and address the collective action problem that has prevented some banks from curtailing distributions such as discretionary bonuses and high dividends, even in the face of deteriorating capital positions.

A countercyclical buffer within a range of 0% – 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances. The purpose of the countercyclical buffer is to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth. For any given country, this buffer will only be in effect when there is excess credit growth that is resulting in a system wide build up of risk. The countercyclical buffer, when in effect, would be introduced as an extension of the conservation buffer range.

These capital requirements are supplemented by a non-risk-based leverage ratio that will serve as a backstop to the risk-based measures described above. In July, Governors and Heads of Supervision agreed to test a minimum Tier 1 leverage ratio of 3% during the parallel run period. Based on the results of the parallel run period, any final adjustments would be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.

Systemically important banks should have loss absorbing capacity beyond the standards announced today and work continues on this issue in the Financial Stability Board and relevant Basel Committee work streams. The Basel Committee and the FSB are developing a well integrated approach to systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt. In addition, work is continuing to strengthen resolution regimes. The Basel Committee also recently issued a consultative document [Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability](#). Governors and Heads of Supervision endorse the aim to strengthen the loss absorbency of non-common Tier 1 and Tier 2 capital instruments.

Transition arrangements

Since the onset of the crisis, banks have already undertaken substantial efforts to raise their capital levels. However, preliminary results of the Committee's comprehensive quantitative impact study show that as of the end of 2009, large banks will need, in the aggregate, a significant amount of additional capital to meet



these new requirements. Smaller banks, which are particularly important for lending to the SME sector, for the most part already meet these higher standards.

The Governors and Heads of Supervision also agreed on transitional arrangements for implementing the new standards. These will help ensure that the banking sector can meet the higher capital standards through reasonable earnings retention and capital raising, while still supporting lending to the economy. The transitional arrangements, which are summarised in Annex 2, include:

- National implementation by member countries will begin on 1 January 2013. Member countries must translate the rules into national laws and regulations before this date. As of 1 January 2013, banks will be required to meet the following new minimum requirements in relation to risk-weighted assets (RWAs):
 - 3.5% common equity/RWAs;
 - 4.5% Tier 1 capital/RWAs, and
 - 8.0% total capital/RWAs.

The minimum common equity and Tier 1 requirements will be phased in between 1 January 2013 and 1 January 2015. On 1 January 2013, the minimum common equity requirement will rise from the current 2% level to 3.5%. The Tier 1 capital requirement will rise from 4% to 4.5%. On 1 January 2014, banks will have to meet a 4% minimum common equity requirement and a Tier 1 requirement of 5.5%. On 1 January 2015, banks will have to meet the 4.5% common equity and the 6% Tier 1 requirements. The total capital requirement remains at the existing level of 8.0% and so does not need to be phased in. The difference between the total capital requirement of 8.0% and the Tier 1 requirement can be met with Tier 2 and higher forms of capital.

- The regulatory adjustments (ie deductions and prudential filters), including amounts above the aggregate 15% limit for investments in financial institutions, mortgage servicing rights, and deferred tax assets from timing differences, would be fully deducted from common equity by 1 January 2018.
- In particular, the regulatory adjustments will begin at 20% of the required deductions from common equity on 1 January 2014, 40% on 1 January 2015, 60% on 1 January 2016, 80% on 1 January 2017, and reach 100% on 1 January 2018. During this transition period, the remainder not deducted from common equity will continue to be subject to existing national treatments.
- The capital conservation buffer will be phased in between 1 January 2016 and year end 2018 becoming fully effective on 1 January 2019. It will begin at 0.625% of RWAs on 1 January 2016 and increase each subsequent year by an additional 0.625 percentage points, to reach its final level of 2.5% of RWAs on 1 January 2019. Countries that experience excessive credit growth should consider accelerating the build up of the capital conservation buffer and the countercyclical buffer. National authorities have the discretion to impose shorter transition periods and should do so where appropriate.
- Banks that already meet the minimum ratio requirement during the transition period but remain below the 7% common equity target



(minimum plus conservation buffer) should maintain prudent earnings retention policies with a view to meeting the conservation buffer as soon as reasonably possible.

- Existing public sector capital injections will be grandfathered until 1 January 2018. Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be phased out over a 10 year horizon beginning 1 January 2013. Fixing the base at the nominal amount of such instruments outstanding on 1 January 2013, their recognition will be capped at 90% from 1 January 2013, with the cap reducing by 10 percentage points in each subsequent year. In addition, instruments with an incentive to be redeemed will be phased out at their effective maturity date.
- Capital instruments that do not meet the criteria for inclusion in common equity Tier 1 will be excluded from common equity Tier 1 as of 1 January 2013. However, instruments meeting the following three conditions will be phased out over the same horizon described in the previous bullet point: (1) they are issued by a non-joint stock company¹; (2) they are treated as equity under the prevailing accounting standards; and (3) they receive unlimited recognition as part of Tier 1 capital under current national banking law.
- Only those instruments issued before the date of this press release should qualify for the above transition arrangements.

Phase-in arrangements for the leverage ratio were announced in the 26 July 2010 press release of the Group of Governors and Heads of Supervision. That is, the supervisory monitoring period will commence 1 January 2011; the parallel run period will commence 1 January 2013 and run until 1 January 2017; and disclosure of the leverage ratio and its components will start 1 January 2015. Based on the results of the parallel run period, any final adjustments will be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.

After an observation period beginning in 2011, the liquidity coverage ratio (LCR) will be introduced on 1 January 2015. The revised net stable funding ratio (NSFR) will move to a minimum standard by 1 January 2018. The Committee will put in place rigorous reporting processes to monitor the ratios during the transition period and will continue to review the implications of these standards for financial markets, credit extension and economic growth, addressing unintended consequences as necessary.

The **Basel Committee on Banking Supervision** provides a forum for regular cooperation on banking supervisory matters. It seeks to promote and strengthen supervisory and risk management practices globally. The Committee comprises representatives from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

¹ Non-joint stock companies were not addressed in the Basel Committee's 1998 agreement on instruments eligible for inclusion in Tier 1 capital as they do not issue voting common shares.



The **Group of Central Bank Governors and Heads of Supervision** is the governing body of the Basel Committee and is comprised of central bank governors and (non-central bank) heads of supervision from member countries. The Committee's Secretariat is based at the Bank for International Settlements in Basel, Switzerland.



Annex 1

Calibration of the Capital Framework			
Capital requirements and buffers (all numbers in percent)			
	Common Equity (after deductions)	Tier 1 Capital	Total Capital
Minimum	4.5	6.0	8.0
Conservation buffer	2.5		
Minimum plus conservation buffer	7.0	8.5	10.5
Countercyclical buffer range*	0 – 2.5		

* Common equity or other fully loss absorbing capital



Annex 2: Phase-in arrangements (shading indicates transition periods)
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	



Global Regulation Risk Management

Keith Checkley FCBI
Chartered Banker

September 2019



Workshop Objectives:

- “... Participants will gain an advanced knowledge and critical understanding of the principles and practices of modern international Enterprise Risk Management.
- They will explore, recognize and appreciate the *complexity inherent in managerial decisions relevant to risk within business portfolios.*”



ERM Defined:

“... 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 risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.”

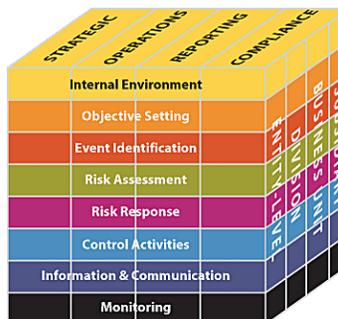
Source: *COSO Enterprise Risk Management – Integrated Framework*. 2004. COSO.



The ERM Framework

Entity objectives can be viewed in the context of four categories:

- Strategic
- Operations
- Reporting
- Compliance

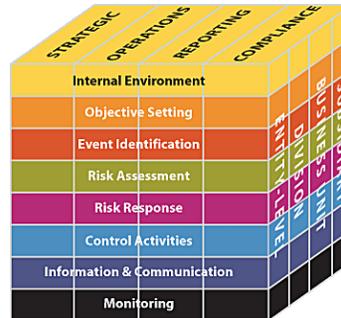




The ERM Framework

ERM considers activities at all levels of the organization:

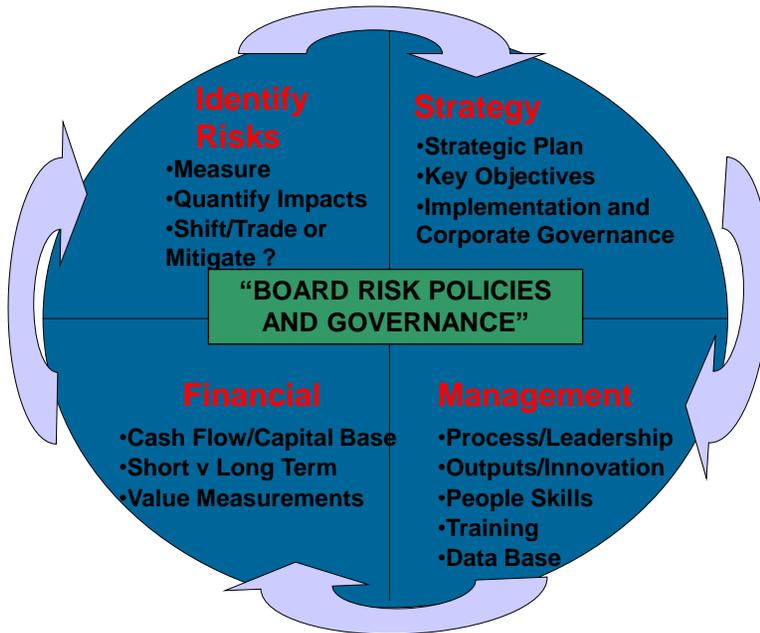
- Enterprise-level
- Division
- Business unit processes
- or Subsidiary



The ERM Framework

The eight components of the framework are interrelated ...





Executive Overview

Basel II and III - New Challenges

Keith Checkley FCIB
Chartered Banker

September 2019



Basel III - Strengthening the global capital framework

- The Basel Committee is raising the resilience of the banking sector by strengthening the regulatory capital framework, *building on the three pillars of the Basel II framework*.
- The reforms raise both the quality and quantity of the regulatory capital base and also enhances firms liquidity management and risk coverage of the capital framework.
- They are underpinned by a leverage ratio that serves as a backstop to the risk-based capital measures, which is intended to constrain excess leverage in the banking system and provide an extra layer of protection against model risk and measurement error.



Challenges of Basel II and III

- Basel II and III are complex topics and mean challenges to the way in which we manage Financial Institutions.
- Different countries and regions will face some unique difficulties in adoption and implementation; depending on economic and structural issues
- However; Basel II and III provide frameworks for Firm wide Risk Management; to include all the risks facing the business ??



Basel II, in Summary

The First Pillar – Choices in calculation

	Basic	Intermediate	Advanced
Credit Risk	'Standardised' Successor to the 1988 Accord with some additional sensitivities	'Foundation' – internal rating based approach Portfolio split by category of exposure – input from institution and regulator	'Advanced' – internal rating-based approach As for Foundation but all parameters calculated by institution.
Market Risk	No major change in current approach		
Operational Risk*	'Basic Indicator Approach' Capital charge based on single risk indicator	'Standardised Approach' Capital charge based on sum of 8 Business Line risk indicators, each calculated by defined industry standards	'Advanced Measurement Approach' Capital charge by Business Line, internally calculated and variable on level of risk



Towards Basel III



BASEL COMMITTEE ON BANKING SUPERVISION
BANK FOR INTERNATIONAL SETTLEMENTS

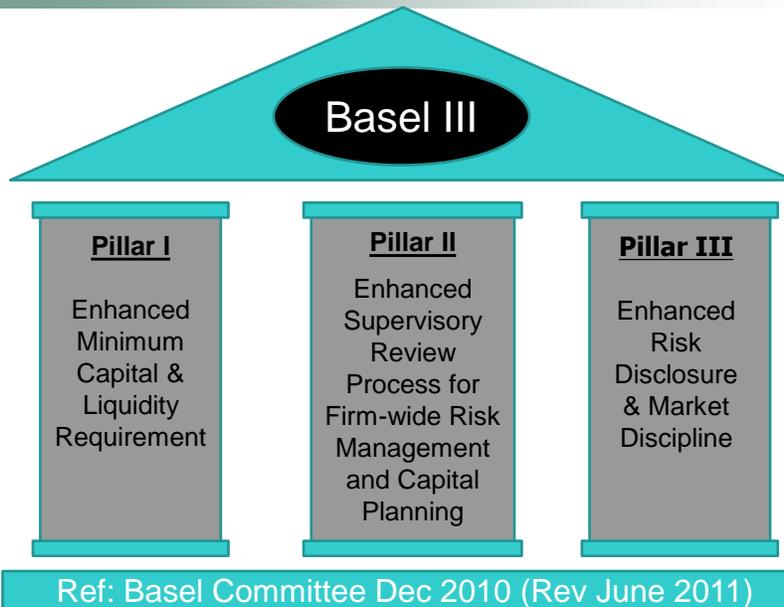
Press release

Press enquiries: +41 61 280 8188
press@bis.org
www.bis.org

Ref no: 35/2010

12 September 2010

**Group of Governors and Heads of Supervision
announces higher global minimum capital standards**



BASEL COMMITTEE ON BANKING SUPERVISION



BANK FOR INTERNATIONAL SETTLEMENTS

Annex 2: Phase-in arrangements (shading indicates transition periods)
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio		Supervisory monitoring			Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosures starts 1 Jan 2015			Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital						Phased out over 10 year horizon beginning 2013			
Liquidity coverage ratio		Observation period begins				Introduce minimum standard			
Net stable funding ratio			Observation period begins					Introduce minimum standard	



Extract from: Basel III

A global regulatory framework for more resilient banks and banking *

- This document, together with the document Basel III: International framework for liquidity risk measurement standards and monitoring; *presents the Basel Committee's reforms to strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector.*
- The objective of the reforms is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy.
- * Ref: BIS December 2010 (revised June 2011).
Available at <http://www.bis.org/publ/bcbs189.pdf>.



Continued

- The Committee's comprehensive reform package addresses the lessons of the financial crisis.
- Through its reform package, the Committee also aims to improve risk management and governance as well as strengthen banks' transparency and disclosures.
- Moreover, the reform package includes the Committee's efforts to strengthen the resolution of systemically significant cross-border banks. (SIFI's)



Continued

- A strong and resilient banking system is the foundation for sustainable economic growth, as banks are at the centre of the credit intermediation process between savers and investors.
- Moreover, banks provide critical services to consumers, small and medium-sized enterprises, large corporate firms and governments who rely on them to conduct their daily business, both at a domestic and international level.



Continued

- One of the main reasons the economic and financial crisis, which began in 2007, became so severe was that the banking sectors of many countries had built up excessive on- and off-balance sheet leverage.
- This was accompanied by a gradual erosion of the level and quality of the capital base. At the same time, many banks were holding insufficient liquidity buffers.
- The banking system therefore was not able to absorb the resulting systemic trading and credit losses nor could it cope with the reintermediation of large off-balance sheet exposures that had built up in the shadow banking system.



Continued

- During the most severe episode of the crisis, the market lost confidence in the solvency and liquidity of many banking institutions.
- The weaknesses in the banking sector were rapidly transmitted to the rest of the financial system and the real economy, resulting in a massive contraction of liquidity and credit availability.
- Ultimately the public sector had to step in with unprecedented injections of liquidity, capital support and guarantees, exposing taxpayers to large losses.



Continued

- To address the market failures revealed by the crisis, the Committee is introducing a number of fundamental reforms to the international regulatory framework.
- The reforms strengthen bank-level, or microprudential, regulation, which will help raise the resilience of individual banking institutions to periods of stress.
- The reforms also have a macroprudential focus, addressing system-wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time.
- Clearly these micro and macroprudential approaches to supervision are interrelated, as greater resilience at the individual bank level reduces the risk of system-wide shocks.



Breaking News.....September 2011

- City rogue trader Kweku Adoboli arrested over \$2bn UBS loss
- Kweku Adoboli, a 31-year old trader at UBS, has been arrested by City of London police in connection with rogue trading that has cost the Swiss banking giant an estimated \$2bn (£1.3bn). The Telegraph – 15 Sep 2011
- The bank said in a statement: "UBS has discovered a loss due to unauthorized trading by a trader in its Investment bank. "The matter is still being investigated, but UBS's current estimate of the loss on the trades is in the range of \$2bn."

23



Breaking News.....January 2012

- Stanford's billionaire lifestyle funded by years of "lying, theft and bribery" – investors cash used for Ponzi scheme, trial told
- In a dramatic opening to the trial in Houston, the prosecution claimed that Mr. Stanford had practised deceit for more than two decades
- His Antigua based Bank collapsed and more than 20,000 investors have received nothing since his arrest in June 2009

24



Breaking News.....June 2012

- Stanford handed 110 year sentence
- Orchestrated a Ponzi scheme that defrauded Investors of more than £7bn.
- US authorities described Stanford as a ruthless predator
- Stanford's fall from grace for a man who was listed in Forbes magazine as the 605th richest man in the world and was worth an estimated \$2bn by 2008
- Stanford promised investors handsome returns if they bought certificates from SIB based in Antigua
- Source of discomfort in English Cricket board due to promotion of games between WI and England

25



Breaking News.....June 2012

- Gupta convicted of Insider Trading
- Former Goldman Sachs Director and ex-head of McKinsey & Co convicted of conspiracy and securities fraud; related to trading in Goldman stock by Raj Rajaratnam's Galleon Hedge fund
- Rajaratnam, who was convicted of 14 counts of insider trading at a trial last year is now serving an 11 year prison sentence
- Gupta is scheduled to be sentenced in October.

26



Breaking News.....July 2012

“Diamond and senior aide forced to quit”

- Bob Diamond, Chief Executive of Barclays, and one of his most senior lieutenants were forced to resign after the bank came under pressure to remove senior executives over Libor rigging
- Barclays were fined the previous week a total of £290m to settle with US and the British regulators

27



Breaking News.....July 2012

July 26th:

- Barclays fourth major resignation –

Alison Carnwarth, Head of Remuneration Committee; who outraged shareholders by approving Bob Diamond £17m pay package; is leaving to devote time to other interests.

- <http://www.telegraph.co.uk/finance>

28



Breaking News.....February 2013

“interest Rate fix shakes three continents”

- London - RBS fined £390m over Libor
- Frankfurt – Deutsche Bank suspends 5 traders
- Tokyo – Claims of cartel involvement in Japan rate

29



Breaking News.....April 2013

“Former HBOS chief gives up his knighthood”

- Former HBOS chief is to give up his knighthood and a third of his pension after a scathing report into the Bank’s collapse
- Sir James Crosby was chief executive of HBOS from 2001 until 2006
- HBOS collapsed in 2008 forcing a £20.5billion taxpayer bailout

30

Case Study: Balance sheet summary

Table 1

	2001	2008	CAGR
Group	(£bn)	(£bn)	(%)
Customer Loans	201.0	435.2	12.6
Customer Deposits	140.5	222.3	7.8
Total Assets	274.7	630.9	12.6
Tangible Shareholders Equity (£m)	9,823	17,792	10.4
Loans/Deposits Ratio (%)	143	196	
Wholesale funding < 1 year	89.8	119.4	
Leverage (Assets/TSE) (x)	28	35	
Retail			
Customer Loans	132.1	255.3	9.9
Customer Deposits	102.0	143.7	5.0
Corporate (including Business Banking in 2001)			
Customer Loans	55.1	123.0	14.4
Customer Deposits	22.2	38.5	10.5
International			
Customer Loans	14.4	61.0	29.5
Customer Deposits	3.7	6.6	29.6
Treasury			
Deposits	12.6	33.5	15.0
Insurance & Investment			
General Insurance (Gross Written Premiums) (£m)	1,064	1,799	7.8
Investment Sales	7.79	11.2	5.3

Breaking News..... 2013

The FSA has now become two separate regulatory authorities and this site is no longer updated.
 The Financial Conduct Authority can be found at www.fca.org.uk and the Prudential Regulation Authority at www.bankofengland.co.uk
 Archived versions of the FSA site are available at the National Archives

FSA

Google Custom Search

[About us](#) - [Doing business with us](#) - [FSA Library](#) - [FSA Handbook](#) - [The FSA Register](#) - [Consumer information](#)

The FSA has now become two separate regulatory authorities and this site is no longer updated.

This site is no longer updated

Archived versions of the FSA site are available at the National Archives.
 The new regulatory authorities and a description of their responsibilities is below.

The Financial Conduct Authority (FCA) can be found at www.fca.org.uk

The FCA regulate the financial services industry in the UK. Their aim is to protect consumers, ensure the industry remains stable and promote healthy competition between financial services providers.

FCA regulatory systems can now be found at:

- > GABRIEL
- > Online Notifications and Applications (ONA)
- > Financial Services Register
- > Transaction reporting
- > Handbook
- > Common-data
- > Contact the FCA

The Prudential Regulation Authority (PRA) can be found at www.bankofengland.co.uk

The PRA is a part of the Bank of England and responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. It sets standards and supervises financial institutions at the level of the individual firm.

PRA information you may find useful:

- > About the PRA
- > Solvency II
- > CRD IV
- > Contact the PRA

Useful sites

- 1 Financial Conduct Authority (FCA)
- 2 Prudential regulatory Authority (PRA)
- 3 Financial Ombudsman Service
- 4 Financial Services Compensation Scheme
- 5 Money Advice Service



Breaking News.....May 2013

“Co-op Bank bosses face possible clawback of bonuses”

- The move follows a six-notch downgrade of the Bank by Moody's
- In March the Co-op Bank reported a surprise loss of £634m after seeing its impairment losses on bad debts more than treble to £469m
- CEO of the Bank resigned in the wake of the downgrade
- Review underway as to sustainability of the banking business



Breaking News.....May 2015

“HSBC to pay £28m after money laundering investigation”

- The bank will pay the money – a record sum for the prosecutor – to close the investigation into “suspected aggravated money laundering” without any admission of wrongdoing.
- **Authorities in Geneva raided offices in February**, after several media organisations published details of how HSBC's private bank in Switzerland aided wealthy clients avoid paying tax and helped drug and weapons smugglers launder money.
- “HSBC Private Bank [in Switzerland] has acknowledged that the compliance culture and standards of due diligence in place in the Bank in the past were not as robust as they are today,” the bank said in a statement.

<https://youtu.be/7kS0-yKLgjk?t=8>



Breaking News.....June 2016

“ Libor-rigging trial: ex-Barclays traders jailed for two to six years”

- The sentences come four years after Barclays became the first of 11 banks and brokerages to be slapped with hefty fines for their role in the rate-fixing scandal, [prompting a political backlash that forced out former chief executive Bob Diamond](#), an overhaul of Libor rules and the criminal inquiry.
- The men had faced sentences of up to 10 years after they were each charged with one count of conspiracy to defraud by plotting to rig Libor (London interbank offered rate), a benchmark for rates on around \$450tn of financial contracts and loans, between June 2005 and September 2007.



Breaking News.....June 2016

“ Former trader Jérôme Kerviel wins unfair dismissal case”

- A French tribunal has ordered [Société Générale](#) to pay €450,000 in damages for unfairly firing the rogue trader [Jérôme Kerviel](#), whose unauthorised trades spiraled into massive losses in 2007 and 2008 and almost bankrupted one of Europe’s biggest banks.
- SocGen said it would appeal



Breaking News....2018

- “Danske Bank money laundering 'is biggest scandal in Europe'
- The [European commission](#) has described the €200bn (£178bn) money-laundering case at Denmark's largest bank as “the biggest scandal” in Europe.
- Věra Jourová, the European commissioner for justice, said she would summon ministers from Denmark and [Estonia](#) to explain how Danske Bank executives and regulators missed the scandal.



Breaking News....2018

“Wells Fargo customers are fed up. They could yank billions of dollars in deposits

- An industry-high 30% of Wells Fargo's ([WFC](#)) customers are at risk of dumping the [scandal-ridden bank](#), according to a report published on Wednesday by consulting firm cg42.
- The report, based on an online survey of 4,000 Americans, projected that Wells Fargo could lose \$93 billion in deposits over the next year. That would represent about 7% of the bank's total deposits.
- Cg42 found that a growing number of [Wells Fargo customers are fed up](#) with the nation's third-largest lender. Their top complaint is that their bank was engaged in “dishonest, unethical or illegal practices.” Others bemoaned that Wells Fargo is trying to sell them products they don't want or need.



Breaking News....November 2018

“Deutsche Bank raided in money-laundering inquiry” – Friday 30th November, The Times

- Police raided six Deutsche Bank offices in and around Frankfurt yesterday as part of an investigation into money-laundering allegations linked to the Panama Papers.
- Prosecutors allege that two un-named employees helped clients to set up offshore firms to launder money
- Deutsche is the biggest Bank in Germany and the 17th biggest in the world
- In September BaFin - the German financial watchdog, ordered Deutsche to do more to prevent money laundering and terrorist financing.
- Last year the bank was fined almost \$700m for allowing monet laundering through artificial trades between Moscow, London and New York.



Breaking News....June 2019

- *“Basel - Overview of Pillar 2 supervisory review practices and approaches”*
<https://www.bis.org/bcbs/publ/d465.htm>
- The [Overview of Pillar 2 supervisory review practices and approaches](#) describes key concepts of Pillar 2 and supervisory review practices in use across Basel Committee member jurisdictions.
- The Pillar 2 supervisory review process is an integral part of the Basel Framework. When the Committee introduced the Basel II framework in 2004, a fundamental objective of the Committee’s work was to reinforce the minimum capital requirements of the first pillar with a robust implementation of the second pillar.
- The report covers key areas of the Pillar 2 supervisory review process, including the risk assessment process, risk appetites, board and senior management roles and supervisory practices adopted to enhance transparency, and bank disclosure practices.
- The report further describes a number of selected Pillar 2 risks, including business risk and interest rate risk in the banking book.



Business Dashboard:

- Eurozone: Dead end

.....or crossroads ?



Strengthening the global capital framework

- Pillar 1 key aspects:

- Raise capital quality and quantity
- Plus – capital conservation buffer
- Plus – countercyclical capital buffer
- Plus – leverage ratio
- Plus – liquidity standards and ratios
- *Plus Systemically Important Financial Institutions – additional considerations*



Raising the quality, consistency and transparency of the capital base

- It is critical that banks' risk exposures are backed by a high quality capital base. The crisis demonstrated that credit losses and write downs come out of retained earnings, which is part of banks' tangible common equity base.
- It also revealed the inconsistency in the definition of capital across jurisdictions and the lack of disclosure that would have enabled the market to fully assess and compare the quality of capital between institutions.
- To this end, the predominant form of Tier 1 capital must be common shares and retained earnings.



Capital conservation buffer

- A capital conservation buffer of 2.5%, comprised of Common Equity Tier 1, is established above the regulatory minimum capital requirement.
- Capital distribution constraints will be imposed on a bank when capital levels fall within this range.
- Banks will be able to conduct business as normal when their capital levels fall into the conservation range as they experience losses.
- The constraints imposed only relate to distributions, not the operation of the bank.



Counter-cyclical buffer

- Losses incurred in the banking sector can be extremely large when a downturn is preceded by a period of excess credit growth.
- These losses can destabilise the banking sector and spark a vicious circle, whereby problems in the financial system can contribute to a downturn in the real economy that then feeds back on to the banking sector.
- These interactions highlight the particular importance of the banking sector building up additional capital defences.



National counter-cyclical buffer requirements

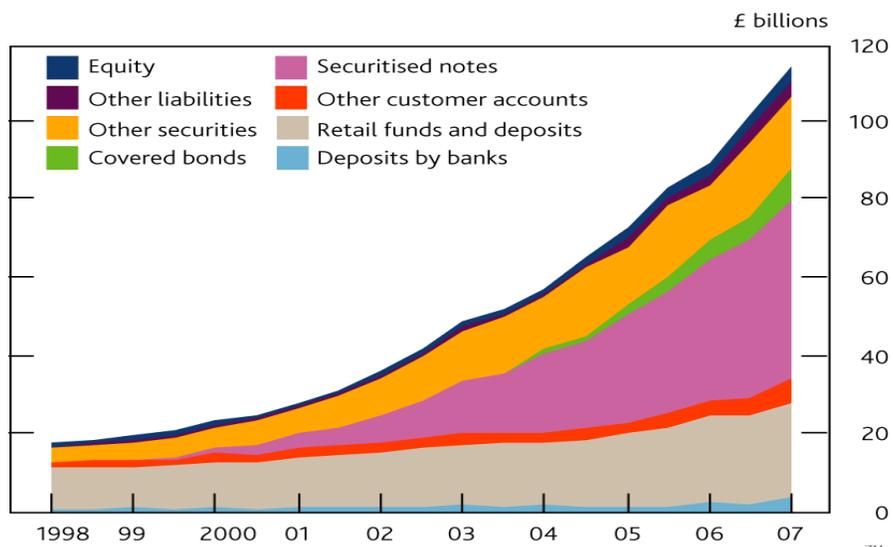
- Each Basel Committee member jurisdiction will identify an authority with the responsibility to make decisions on the size of the countercyclical capital buffer.
- If the relevant national authority judges a period of excess credit growth to be leading to the build up of system-wide risk, they will consider, together with any other macroprudential tools at their disposal, putting in place a countercyclical buffer requirement.
- This will vary between zero and 2.5% of risk weighted assets, depending on their judgment as to the extent of the build up of system-wide risk.



Is a Leverage ratio needed ?



Extract from Northern Rock balance sheet





Supplementing the risk-based capital requirement with a leverage ratio

- One of the underlying features of the crisis was the build up of excessive on- and off-balance sheet leverage in the banking system.
- The build up of leverage also has been a feature of previous financial crises, for example leading up to September 1998.
- During the most severe part of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices



Leverage Ratio

The Committee therefore is introducing a leverage ratio requirement that is intended to achieve the following objectives:

- constrain leverage in the banking sector, thus helping to mitigate the risk of the de-stabilising deleveraging processes which can damage the financial system and the economy; and
- introduce additional safeguards against model risk and measurement error by supplementing the risk-based measure with a simple, transparent, independent measure of risk.



Leverage Ratio

- The leverage ratio is calculated in a comparable manner across jurisdictions, adjusting for any differences in accounting standards.
- The Committee has designed the leverage ratio to be a credible supplementary measure to the risk-based requirement with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration (– see timetable)

- Leverage ratio = Tier 1 Capital / Total Assets



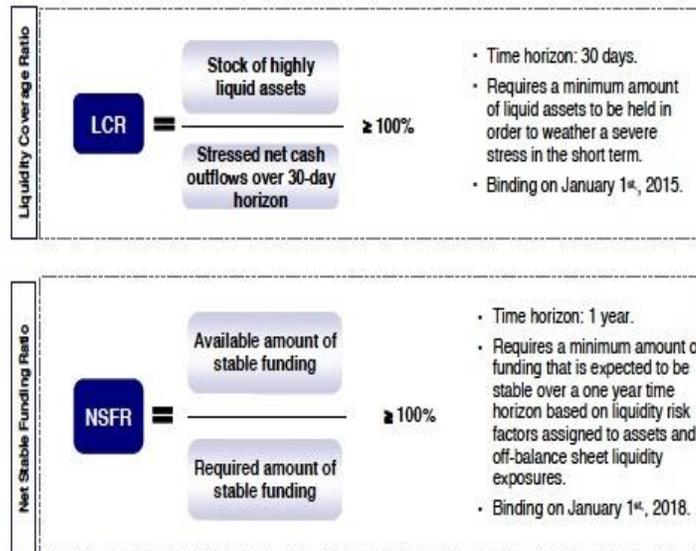
Introducing a Global Liquidity Standard

- The recent crisis highlighted the importance of prudent liquidity risk management. In response, in 2008 the BCBS published its *Principles for Sound Liquidity Risk Management and Supervision*, to promote stronger governance, risk management, disclosure and robust supervision of banks' liquidity management frameworks.[1]
- To complement these principles, the BCBS proposed, as part of Basel III, two *minimum* quantitative standards for funding liquidity: the Liquidity Coverage Ratio and the Net Stable Funding Ratio.[2]

■ [1] BCBS, 2008, *Principles for Sound Liquidity Risk Management and Supervision*. Available at: <http://www.bis.org/publ/bcbs144.pdf>.

■ [2] BCBS, 2010, *Basel III International Framework for Liquidity Risk Measurement, Standards and Monitoring*. Available at: <http://www.bis.org/publ/bcbs188.htm>.

Short description of the two ratios



Introducing a Global Liquidity Standard

- These standards have been developed to achieve two separate but complementary objectives.
- The first objective is to promote short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high quality liquid resources to survive an acute stress scenario lasting for one month.
- The Committee developed the Liquidity Coverage Ratio (LCR) to achieve this objective.



Introducing a Global Liquidity Standard

- The second objective is to promote resilience over a longer time horizon by creating additional incentives for a bank to fund its activities with more stable sources of funding on an ongoing structural basis.
- The Net Stable Funding Ratio (NSFR) has a time horizon of one year and has been developed to provide a sustainable maturity structure of assets and liabilities.



Introducing a Global Liquidity Standard

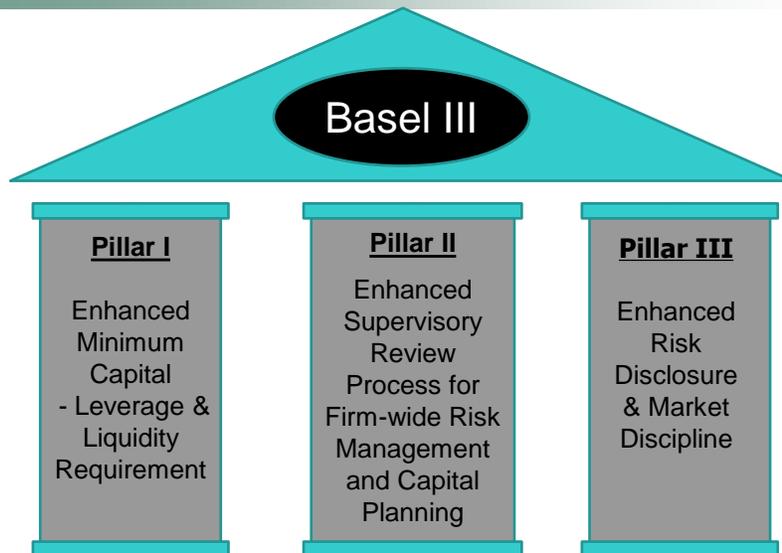
- The NSFR requires a minimum amount of stable sources of funding at a bank relative to the liquidity profiles of the assets, as well as the potential for contingent liquidity needs arising from off-balance sheet commitments, over a one-year horizon.
- The NSFR aims to limit over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items.



Annex 2: Phase-in arrangements (shading indicates transition periods)
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio		Supervisory monitoring							
			Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosures starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital						Phased out over 10 year horizon beginning 2013			
Liquidity coverage ratio		Observation period begins				Introduce minimum standard			
Net stable funding ratio			Observation period begins					Introduce minimum standard	

DTAs – Deferred Tax Assets
MSRs – Mortgage Servicing Rights



Ref: Basel Committee Dec 2010 (Rev June 2011)

Basel Committee on Banking Supervision reforms - Basel III

Strengthens microprudential regulation and supervision, and adds a macroprudential overlay that includes capital buffers.

Capital					Liquidity
Capital	Pillar 1	Containing leverage	Pillar 2	Pillar 3	Global Liquidity standard and supervisory monitoring
<p>Quality and level of capital Greater focus on common equity. The minimum will be raised to 4.5% of risk-weighted assets, after deductions.</p> <p>"Gone concern" contingent capital "gone concern" capital proposal would require contractual terms of capital instruments to include a clause allowing – at the discretion of the relevant authority – write-off or conversion to common shares if the bank is judged to be non-viable. "Gone concern" contingent capital increases the contribution of the private sector to resolving future banking crises and thereby reduces moral hazard.</p> <p>Capital conservation buffer Comprising common equity of 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. Constraint on a bank's discretionary distributions will be imposed when banks fall into the buffer range.</p> <p>Countercyclical buffer Imposed within a range of 0-2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build up of systematic risk.</p>	<p>Securitisations Strengthens the capital treatment for certain complex securitisations. Requires banks to conduct more rigorous credit analyses of externally rated securitisation exposures.</p> <p>Trading book Significantly higher capital for trading and derivatives activities, as well as complex securitisations held in the trading book. Introduction of a stressed value-at-risk framework to help mitigate procyclicality.</p> <p>Counterparty credit risk Substantial strengthening of the counterparty credit risk framework. Includes more stringent requirements for measuring exposure; capital incentives for banks to use central counterparties for derivatives; and higher capital for inter-financial sector exposures.</p>	<p>Leverage ratio A non-risk-based leverage ratio that includes off-balance sheet exposures will serve as a backstop to the risk-based capital requirement. Also helps contain system wide build up of leverage.</p>	<p>Supplemental Pillar 2 requirements. Address firm-wide governance and risk management, capturing the risk of off-balance sheet exposures and securitisation activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; sound compensation practices; valuation practices; stress testing; accounting standards for financial instruments; corporate governance; and supervisory colleges.</p>	<p>Revised Pillar 3 disclosures requirements The requirements introduced relate to securitisation exposures and sponsorship of off-balance sheet vehicles. Enhanced disclosures on the components of regulatory capital and their reconciliation to the reported accounts will be required, including a comprehensive explanation of how a bank calculates its regulatory capital ratios.</p>	<p>Global Liquidity standard and supervisory monitoring</p> <p>Liquidity coverage ratio The Liquidity coverage ratio (LCR) will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors.</p> <p>Net stable funding ratio The net stable funding ratio (NSFR) is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding.</p> <p>Principles for Sound Liquidity Risk Management and Supervision The Committee's 2008 guidance entitled Principles takes account of lessons learned during the crisis and are based on a fundamental review of sound practices for managing liquidity risk in banking organisations.</p> <p>Supervisory monitoring The Liquidity framework includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank and system-wide level.</p>
<p>SIFIs In addition to meeting the Basel III requirements, global systemically important financial institutions (SIFIs) must have higher loss absorbency capacity to reflect the greater risks that they pose to the financial system. The Committee has developed a methodology that includes both quantitative indicators and qualitative elements to identify global SIFIs. The additional loss absorbency requirements are to be met with a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 3% to 2.5%, depending on a bank's systemic importance. A consultative document was submitted to the Financial Stability Board (FSB), which is coordinating the overall set of measures to reduce the moral hazard posed by global systemically important financial institutions.</p>					



Basel III

Further reading:

- BCBS, 2010(Rev 2011) *Basel III: A global regulatory framework for more resilient banks and banking systems*
 Available at: <http://www.bis.org/publ/bcbs189.pdf>.
- BCBS, 2011, *Principles for the Sound Management of Operational Risk*
 Available at: <http://www.bis.org/publ/bcbs195.pdf>.
- BCBS, 2011, *Operational Risk – Supervisory Guidelines for the Advanced Measurement Approaches*
 Available at: <http://www.bis.org/publ/bcbs196.pdf>.
- BCBS, 2013, *Basel III Liquidity Coverage Ratio and liquidity risk monitoring tools.*
 Available at: <http://www.bis.org/publ/bcbs238.pdf>.
- BCBS, 2014, *Basel III The Net Stable Funding Ratio.*
 Available at: <http://www.bis.org/publ/d295.pdf>.



For Later Debate Session

MEDIA RELEASE



International Organization of Securities Commissions
Organisation internationale des commissions de valeurs
Organizaç o Internacional das Comiss es de Valores
Organizaci n Internacional de Comisiones de Valores

IOSCO/MR08/2012

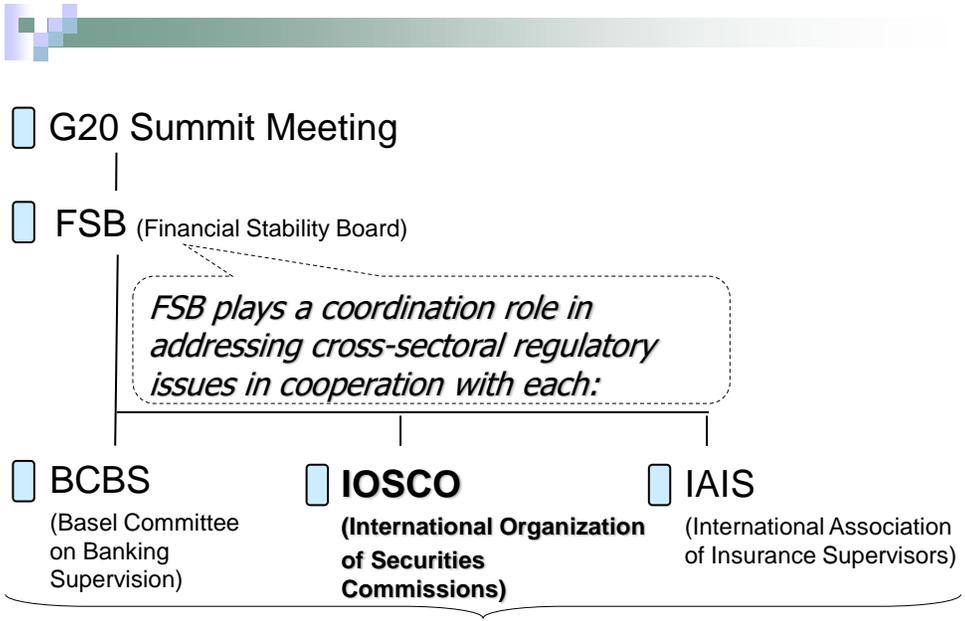
Beijing, 16 May 2012

IOSCO Prepares for the Regulatory and Financial Challenges Ahead



➤ **IOSCO Principles and Standards**

- Although IOSCO was created in 1983, the financial crisis has served to bring new focus to international regulatory standards and co-operation.
- IOSCO's 30 principles of securities regulation have received support from the G20 group of countries and the Financial Stability Board.
- These principles are based on three objectives of securities regulation which are:
 1. the protection of investors;
 2. ensuring that markets are fair, efficient and transparent;
 3. the reduction of systemic risk.



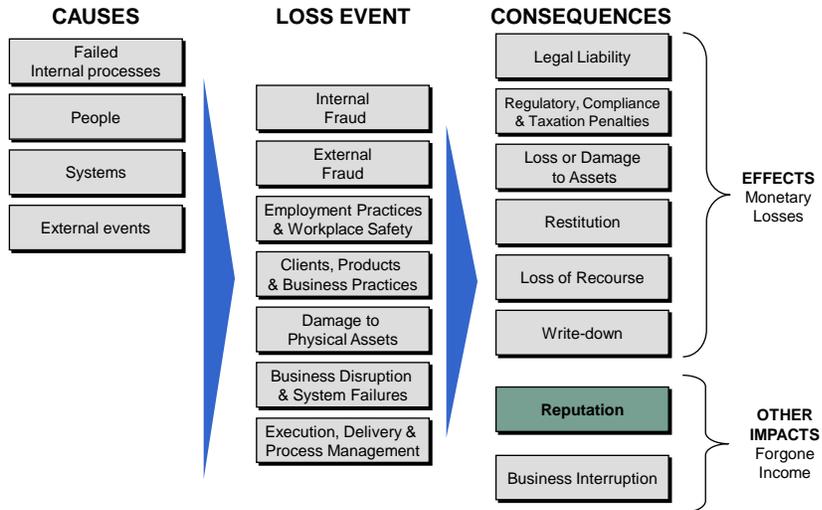
Masamichi Kono
Chair, IOSCO Technical Committee

Seminar Discussion

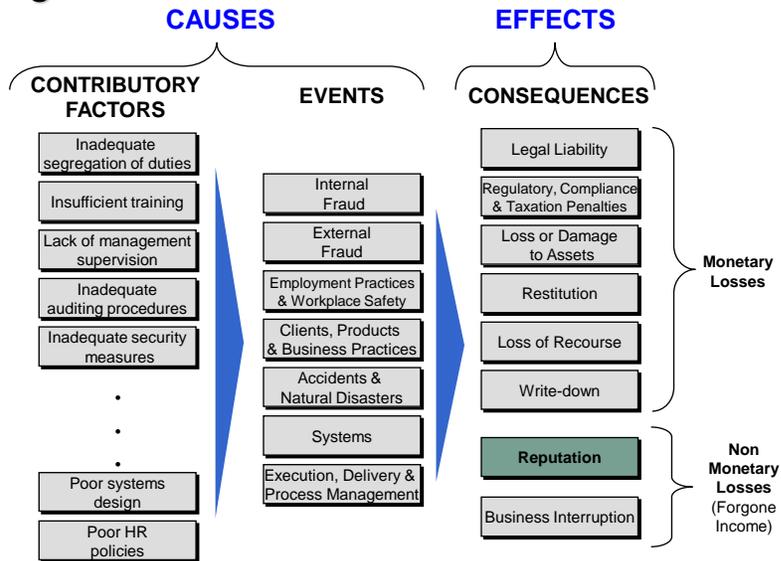
- Risk Management Issues

Barings Bank Case Study

The Three Dimensions of OR



Cause & Effect – Developing a Risk Register



Turner Report Extract – Market Risk



The Turner Review
Chapter One: What went wrong?

22

1.1 (iv) Misplaced reliance on sophisticated maths

The increasing scale and complexity of the securitised credit market was obvious to individual participants, to regulators and to academic observers. But the predominant assumption was that increased complexity had been matched by the evolution of mathematically sophisticated and effective techniques for measuring and managing the resulting risks. Central to many of the techniques was the concept of Value-at-Risk (VAR), enabling inferences about forward-looking risk to be drawn from the observation of past patterns of price movement. This technique, developed in the early 1990s, was not only accepted as standard across the industry, but adopted by regulators as the basis for calculating trading risk and required capital, (being incorporated for instance within the European Capital Adequacy Directive).

Cont'd



The Turner Review
Chapter One: What went wrong?

There are, however, fundamental questions about the validity of VAR as a measure of risk (see Section 1.4 (ii) below). And the use of VAR measures based on relatively short periods of historical observation (e.g. 12 months) introduced dangerous procyclicality into the assessment of trading book risk for the reasons set out in Box 1A (deficiencies of VAR).

The very complexity of the mathematics used to measure and manage risk, moreover, made it increasingly difficult for top management and boards to assess and exercise judgement over the risks being taken. Mathematical sophistication ended up not containing risk, but providing false assurance that other prima facie indicators of increasing risk (e.g. rapid credit extension and balance sheet growth) could be safely ignored.



Minimum Capital Requirements for Market Risk – Jan 2016

- The 2007-08 period of severe market stress exposed weaknesses in the framework for capitalising risks from trading activities. In 2009, the Committee introduced a set of [revisions to the Basel II market risk framework](#) to address the most pressing deficiencies.
- **A fundamental review of the trading book** was also initiated to tackle a number of structural flaws in the framework that were not addressed by those revisions. This has led to the revised market risk framework -



Minimum Capital Requirements for Market Risk – Jan 2016 (cont'd)

- The key features of the revised framework include:
- *A revised boundary between the trading book and banking book*
- *A revised internal models approach for market risk*
- *A revised standardised approach for market risk*
- *A shift from value-at-risk to an expected shortfall measure of risk under stress*
- *Incorporation of the risk of market illiquidity*

The revised market risk framework comes into effect on 1 January 2019.

- BCBS, 2016, Minimum capital requirements for market risk
Available at: <http://www.bis.org/publ/bcbs>

Principles for the Management of Credit Risk

Basel Committee on Banking Supervision

Basel
September 2000

**Risk Management Group
of the Basel Committee on Banking Supervision**

Chairman:

Mr Roger Cole – Federal Reserve Board, Washington, D.C.

Banque Nationale de Belgique, Brussels	Ms Ann-Sophie Dupont
Commission Bancaire et Financière, Brussels	Mr Jos Meuleman
Office of the Superintendent of Financial Institutions, Ottawa	Ms Aina Liepins
Commission Bancaire, Paris	Mr Olivier Prato
Deutsche Bundesbank, Frankfurt am Main	Ms Magdalene Heid
Bundesaufsichtsamt für das Kreditwesen, Berlin	Mr Uwe Neumann
Banca d'Italia, Rome	Mr Sebastiano Laviola
Bank of Japan, Tokyo	Mr Toshihiko Mori
Financial Services Agency, Tokyo	Mr Takushi Fujimoto Mr Satoshi Morinaga
Commission de Surveillance du Secteur Financier, Luxembourg	Mr Davy Reinard
De Nederlandsche Bank, Amsterdam	Mr Klaas Knot
Finansinspektionen, Stockholm	Mr Jan Hedquist
Sveriges Riksbank, Stockholm	Ms Camilla Ferenius
Eidgenössische Bankenkommision, Bern	Mr Martin Sprenger
Financial Services Authority, London	Mr Jeremy Quick Mr Michael Stephenson
Bank of England, London	Ms Alison Emblow
Federal Deposit Insurance Corporation, Washington, D.C.	Mr Mark Schmidt
Federal Reserve Bank of New York	Mr Stefan Walter
Federal Reserve Board, Washington, D.C.	Mr David Elkes
Office of the Comptroller of the Currency, Washington, D.C.	Mr Kevin Bailey
European Central Bank, Frankfurt am Main	Mr Panagiotis Strouzas
European Commission, Brussels	Mr Michel Martino
Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements	Mr Ralph Nash Mr Guillermo Rodriguez Garcia

Table of Contents

I.	INTRODUCTION.....	1
	PRINCIPLES FOR THE ASSESSMENT OF BANKS' MANAGEMENT OF CREDIT RISK	3
II.	ESTABLISHING AN APPROPRIATE CREDIT RISK ENVIRONMENT	5
III.	OPERATING UNDER A SOUND CREDIT GRANTING PROCESS	8
IV.	MAINTAINING AN APPROPRIATE CREDIT ADMINISTRATION, MEASUREMENT AND MONITORING PROCESS.....	13
V.	ENSURING ADEQUATE CONTROLS OVER CREDIT RISK	18
VI.	THE ROLE OF SUPERVISORS.....	19
	APPENDIX: COMMON SOURCES OF MAJOR CREDIT PROBLEMS	21

Principles for the Management of Credit Risk

I. Introduction

1. While financial institutions have faced difficulties over the years for a multitude of reasons, the major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management, or a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties. This experience is common in both G-10 and non-G-10 countries.

2. Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. The goal of credit risk management is to maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. Banks should also consider the relationships between credit risk and other risks. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organisation.

3. For most banks, loans are the largest and most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of a bank, including in the banking book and in the trading book, and both on and off the balance sheet. Banks are increasingly facing credit risk (or counterparty risk) in various financial instruments other than loans, including acceptances, interbank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transactions.

4. Since exposure to credit risk continues to be the leading source of problems in banks world-wide, banks and their supervisors should be able to draw useful lessons from past experiences. Banks should now have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they are adequately compensated for risks incurred. The Basel Committee is issuing this document in order to encourage banking supervisors globally to promote sound practices for managing credit risk. Although the principles contained in this paper are most clearly applicable to the business of lending, they should be applied to all activities where credit risk is present.

5. The sound practices set out in this document specifically address the following areas: (i) establishing an appropriate credit risk environment; (ii) operating under a sound credit-granting process; (iii) maintaining an appropriate credit administration, measurement and monitoring process; and (iv) ensuring adequate controls over credit risk. Although specific credit risk management practices may differ among banks depending upon the nature and complexity of their credit activities, a comprehensive credit risk management program will address these four areas. These practices should also be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves,

and the disclosure of credit risk, all of which have been addressed in other recent Basel Committee documents.¹

6. While the exact approach chosen by individual supervisors will depend on a host of factors, including their on-site and off-site supervisory techniques and the degree to which external auditors are also used in the supervisory function, **all members of the Basel Committee agree that the principles set out in this paper should be used in evaluating a bank's credit risk management system.** Supervisory expectations for the credit risk management approach used by individual banks should be commensurate with the scope and sophistication of the bank's activities. For smaller or less sophisticated banks, supervisors need to determine that the credit risk management approach used is sufficient for their activities and that they have instilled sufficient risk-return discipline in their credit risk management processes. The Committee stipulates in Sections II to VI of the paper, principles for banking supervisory authorities to apply in assessing bank's credit risk management systems. In addition, the appendix provides an overview of credit problems commonly seen by supervisors.

7. A further particular instance of credit risk relates to the process of settling financial transactions. If one side of a transaction is settled but the other fails, a loss may be incurred that is equal to the principal amount of the transaction. Even if one party is simply late in settling, then the other party may incur a loss relating to missed investment opportunities. Settlement risk (i.e. the risk that the completion or settlement of a financial transaction will fail to take place as expected) thus includes elements of liquidity, market, operational and reputational risk as well as credit risk. The level of risk is determined by the particular arrangements for settlement. Factors in such arrangements that have a bearing on credit risk include: the timing of the exchange of value; payment/settlement finality; and the role of intermediaries and clearing houses.²

8. This paper was originally published for consultation in July 1999. The Committee is grateful to the central banks, supervisory authorities, banking associations, and institutions that provided comments. These comments have informed the production of this final version of the paper.

¹ See in particular *Sound Practices for Loan Accounting and Disclosure* (July 1999) and *Best Practices for Credit Risk Disclosure* (September 2000).

² See in particular *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions* (September 2000), in which the annotated bibliography (annex 3) provides a list of publications related to various settlement risks.

Principles for the Assessment of Banks' Management of Credit Risk

A. Establishing an appropriate credit risk environment

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.

B. Operating under a sound credit granting process

Principle 4: Banks must operate within sound, well-defined credit-granting criteria. These criteria should include a clear indication of the bank's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.

Principle 5: Banks should establish overall credit limits at the level of individual borrowers and counterparties, and groups of connected counterparties that aggregate in a comparable and meaningful manner different types of exposures, both in the banking and trading book and on and off the balance sheet.

Principle 6: Banks should have a clearly-established process in place for approving new credits as well as the amendment, renewal and re-financing of existing credits.

Principle 7: All extensions of credit must be made on an arm's-length basis. In particular, credits to related companies and individuals must be authorised on an exception basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending.

C. Maintaining an appropriate credit administration, measurement and monitoring process

Principle 8: Banks should have in place a system for the ongoing administration of their various credit risk-bearing portfolios.

Principle 9: Banks must have in place a system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves.

Principle 10: Banks are encouraged to develop and utilise an internal risk rating system in managing credit risk. The rating system should be consistent with the nature, size and complexity of a bank's activities.

Principle 11: Banks must have information systems and analytical techniques that enable management to measure the credit risk inherent in all on- and off-balance sheet activities. The management information system should provide adequate information on the composition of the credit portfolio, including identification of any concentrations of risk.

Principle 12: Banks must have in place a system for monitoring the overall composition and quality of the credit portfolio.

Principle 13: Banks should take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressful conditions.

D. Ensuring adequate controls over credit risk

Principle 14: Banks must establish a system of independent, ongoing assessment of the bank's credit risk management processes and the results of such reviews should be communicated directly to the board of directors and senior management.

Principle 15: Banks must ensure that the credit-granting function is being properly managed and that credit exposures are within levels consistent with prudential standards and internal limits. Banks should establish and enforce internal controls and other practices to ensure that exceptions to policies, procedures and limits are reported in a timely manner to the appropriate level of management for action.

Principle 16: Banks must have a system in place for early remedial action on deteriorating credits, managing problem credits and similar workout situations.

E. The role of supervisors

Principle 17: Supervisors should require that banks have an effective system in place to identify, measure, monitor and control credit risk as part of an overall approach to risk management. Supervisors should conduct an independent evaluation of a bank's strategies, policies, procedures and practices related to the granting of credit and the ongoing management of the portfolio. Supervisors should consider setting prudential limits to restrict bank exposures to single borrowers or groups of connected counterparties.

II. Establishing an Appropriate Credit Risk Environment

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.

9. As with all other areas of a bank's activities, the board of directors³ has a critical role to play in overseeing the credit-granting and credit risk management functions of the bank. Each bank should develop a credit risk strategy or plan that establishes the objectives guiding the bank's credit-granting activities and adopt the necessary policies and procedures for conducting such activities. The credit risk strategy, as well as significant credit risk policies, should be approved and periodically (at least annually) reviewed by the board of directors. The board needs to recognise that the strategy and policies must cover the many activities of the bank in which credit exposure is a significant risk.

10. The strategy should include a statement of the bank's willingness to grant credit based on exposure type (for example, commercial, consumer, real estate), economic sector, geographical location, currency, maturity and anticipated profitability. This might also include the identification of target markets and the overall characteristics that the bank would want to achieve in its credit portfolio (including levels of diversification and concentration tolerances).

11. The credit risk strategy should give recognition to the goals of credit quality, earnings and growth. Every bank, regardless of size, is in business to be profitable and, consequently, must determine the acceptable risk/reward trade-off for its activities, factoring in the cost of capital. A bank's board of directors should approve the bank's strategy for selecting risks and maximising profits. The board should periodically review the financial results of the bank and, based on these results, determine if changes need to be made to the strategy. The board must also determine that the bank's capital level is adequate for the risks assumed throughout the entire organisation.

12. The credit risk strategy of any bank should provide continuity in approach. Therefore, the strategy will need to take into account the cyclical aspects of any economy and the resulting shifts in the composition and quality of the overall credit portfolio. Although the strategy should be periodically assessed and amended, it should be viable in the long-run and through various economic cycles.

13. The credit risk strategy and policies should be effectively communicated throughout the banking organisation. All relevant personnel should clearly understand the bank's

³ This paper refers to a management structure composed of a board of directors and senior management. The Committee is aware that there are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some countries, the board has the main, if not exclusive, function of supervising the executive body (senior management, general management) so as to ensure that the latter fulfils its tasks. For this reason, in some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of the bank. Owing to these differences, the notions of the board of directors and senior management are used in this paper not to identify legal constructs but rather to label two decision-making functions within a bank.

approach to granting and managing credit and should be held accountable for complying with established policies and procedures.

14. The board should ensure that senior management is fully capable of managing the credit activities conducted by the bank and that such activities are done within the risk strategy, policies and tolerances approved by the board. The board should also regularly (i.e. at least annually), either within the credit risk strategy or within a statement of credit policy, approve the bank's overall credit granting criteria (including general terms and conditions). In addition, it should approve the manner in which the bank will organise its credit-granting functions, including independent review of the credit granting and management function and the overall portfolio.

15. While members of the board of directors, particularly outside directors, can be important sources of new business for the bank, once a potential credit is introduced, the bank's established processes should determine how much and at what terms credit is granted. In order to avoid conflicts of interest, it is important that board members not override the credit-granting and monitoring processes of the bank.

16. The board of directors should ensure that the bank's remuneration policies do not contradict its credit risk strategy. Remuneration policies that reward unacceptable behaviour such as generating short-term profits while deviating from credit policies or exceeding established limits, weaken the bank's credit processes.

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.

17. Senior management of a bank is responsible for implementing the credit risk strategy approved by the board of directors. This includes ensuring that the bank's credit-granting activities conform to the established strategy, that written procedures are developed and implemented, and that loan approval and review responsibilities are clearly and properly assigned. Senior management must also ensure that there is a periodic independent internal assessment of the bank's credit-granting and management functions.⁴

18. A cornerstone of safe and sound banking is the design and implementation of written policies and procedures related to identifying, measuring, monitoring and controlling credit risk. Credit policies establish the framework for lending and guide the credit-granting activities of the bank. Credit policies should address such topics as target markets, portfolio mix, price and non-price terms, the structure of limits, approval authorities, exception processing/reporting, etc. Such policies should be clearly defined, consistent with prudent banking practices and relevant regulatory requirements, and adequate for the nature and complexity of the bank's activities. The policies should be designed and implemented within the context of internal and external factors such as the bank's market position, trade area, staff

⁴ This may be difficult for very small banks; however, there should be adequate checks and balances in place to promote sound credit decisions.

capabilities and technology. Policies and procedures that are properly developed and implemented enable the bank to: (i) maintain sound credit-granting standards; (ii) monitor and control credit risk; (iii) properly evaluate new business opportunities; and (iv) identify and administer problem credits.

19. As discussed further in paragraphs 30 and 37 through 41 below, banks should develop and implement policies and procedures to ensure that the credit portfolio is adequately diversified given the bank's target markets and overall credit strategy. In particular, such policies should establish targets for portfolio mix as well as set exposure limits on single counterparties and groups of connected counterparties, particular industries or economic sectors, geographic regions and specific products. Banks should ensure that their own internal exposure limits comply with any prudential limits or restrictions set by the banking supervisors.

20. In order to be effective, credit policies must be communicated throughout the organisation, implemented through appropriate procedures, monitored and periodically revised to take into account changing internal and external circumstances. They should be applied, where appropriate, on a consolidated bank basis and at the level of individual affiliates. In addition, the policies should address equally the important functions of reviewing credits on an individual basis and ensuring appropriate diversification at the portfolio level.

21. When banks engage in granting credit internationally, they undertake, in addition to standard credit risk, risk associated with conditions in the home country of a foreign borrower or counterparty. Country or sovereign risk encompasses the entire spectrum of risks arising from the economic, political and social environments of a foreign country that may have potential consequences for foreigners' debt and equity investments in that country. Transfer risk focuses more specifically on a borrower's capacity to obtain the foreign exchange necessary to service its cross-border debt and other contractual obligations. In all instances of international transactions, banks need to understand the globalisation of financial markets and the potential for spillover effects from one country to another or contagion effects for an entire region.

22. Banks that engage in granting credit internationally must therefore have adequate policies and procedures for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities. The monitoring of country risk factors should incorporate (i) the potential default of foreign private sector counterparties arising from country-specific economic factors and (ii) the enforceability of loan agreements and the timing and ability to realise collateral under the national legal framework. This function is often the responsibility of a specialist team familiar with the particular issues.

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.

23. The basis for an effective credit risk management process is the identification and analysis of existing and potential risks inherent in any product or activity. Consequently, it is important that banks identify all credit risk inherent in the products they offer and the

activities in which they engage. Such identification stems from a careful review of the existing and potential credit risk characteristics of the product or activity.

24. Banks must develop a clear understanding of the credit risks involved in more complex credit-granting activities (for example, loans to certain industry sectors, asset securitisation, customer-written options, credit derivatives, credit-linked notes). This is particularly important because the credit risk involved, while not new to banking, may be less obvious and require more analysis than the risk of more traditional credit-granting activities. Although more complex credit-granting activities may require tailored procedures and controls, the basic principles of credit risk management will still apply.

25. New ventures require significant planning and careful oversight to ensure the risks are appropriately identified and managed. Banks should ensure that the risks of new products and activities are subject to adequate procedures and controls before being introduced or undertaken. Any major new activity should be approved in advance by the board of directors or its appropriate delegated committee.

26. It is critical that senior management determine that the staff involved in any activity where there is borrower or counterparty credit risk, whether established or new, basic or more complex, be fully capable of conducting the activity to the highest standards and in compliance with the bank's policies and procedures.

III. Operating under a Sound Credit Granting Process

Principle 4: Banks must operate within sound, well-defined credit-granting criteria. These criteria should include a clear indication of the bank's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.

27. Establishing sound, well-defined credit-granting criteria is essential to approving credit in a safe and sound manner. The criteria should set out who is eligible for credit and for how much, what types of credit are available, and under what terms and conditions the credits should be granted.

28. Banks must receive sufficient information to enable a comprehensive assessment of the true risk profile of the borrower or counterparty. Depending on the type of credit exposure and the nature of the credit relationship to date, the factors to be considered and documented in approving credits include:

- the purpose of the credit and sources of repayment;
- the current risk profile (including the nature and aggregate amounts of risks) of the borrower or counterparty and collateral and its sensitivity to economic and market developments;
- the borrower's repayment history and current capacity to repay, based on historical financial trends and future cash flow projections, under various scenarios;

- for commercial credits, the borrower’s business expertise and the status of the borrower’s economic sector and its position within that sector;
- the proposed terms and conditions of the credit, including covenants designed to limit changes in the future risk profile of the borrower; and
- where applicable, the adequacy and enforceability of collateral or guarantees, including under various scenarios.

In addition, in approving borrowers or counterparties for the first time, consideration should be given to the integrity and reputation of the borrower or counterparty as well as their legal capacity to assume the liability. Once credit-granting criteria have been established, it is essential for the bank to ensure that the information it receives is sufficient to make proper credit-granting decisions. This information will also serve as the basis for rating the credit under the bank’s internal rating system.

29. Banks need to understand to whom they are granting credit. Therefore, prior to entering into any new credit relationship, a bank must become familiar with the borrower or counterparty and be confident that they are dealing with an individual or organisation of sound repute and creditworthiness. In particular, strict policies must be in place to avoid association with individuals involved in fraudulent activities and other crimes. This can be achieved through a number of ways, including asking for references from known parties, accessing credit registries, and becoming familiar with individuals responsible for managing a company and checking their personal references and financial condition. However, a bank should not grant credit simply because the borrower or counterparty is familiar to the bank or is perceived to be highly reputable.

30. Banks should have procedures to identify situations where, in considering credits, it is appropriate to classify a group of obligors as connected counterparties and, thus, as a single obligor. This would include aggregating exposures to groups of accounts exhibiting financial interdependence, including corporate or non-corporate, where they are under common ownership or control or with strong connecting links (for example, common management, familial ties).⁵ Banks should also have procedures for aggregating exposures to individual clients across business activities.

31. Many banks participate in loan syndications or other such loan consortia. Some institutions place undue reliance on the credit risk analysis done by the lead underwriter or on external commercial loan credit ratings. All syndicate participants should perform their own due diligence, including independent credit risk analysis and review of syndicate terms prior to committing to the syndication. Each bank should analyse the risk and return on syndicated loans in the same manner as directly sourced loans.

32. Granting credit involves accepting risks as well as producing profits. Banks should assess the risk/reward relationship in any credit as well as the overall profitability of the

⁵ Connected counterparties may be a group of companies related financially or by common ownership, management, research and development, marketing or any combination thereof. Identification of connected counterparties requires a careful analysis of the impact of these factors on the financial interdependency of the parties involved.

account relationship. In evaluating whether, and on what terms, to grant credit, banks need to assess the risks against expected return, factoring in, to the greatest extent possible, price and non-price (e.g. collateral, restrictive covenants, etc.) terms. In evaluating risk, banks should also assess likely downside scenarios and their possible impact on borrowers or counterparties. A common problem among banks is the tendency not to price a credit or overall relationship properly and therefore not receive adequate compensation for the risks incurred.

33. In considering potential credits, banks must recognise the necessity of establishing provisions for identified and expected losses and holding adequate capital to absorb unexpected losses. The bank should factor these considerations into credit-granting decisions, as well as into the overall portfolio risk management process.⁶

34. Banks can utilise transaction structure, collateral and guarantees to help mitigate risks (both identified and inherent) in individual credits but transactions should be entered into primarily on the strength of the borrower's repayment capacity. Collateral cannot be a substitute for a comprehensive assessment of the borrower or counterparty, nor can it compensate for insufficient information. It should be recognised that any credit enforcement actions (e.g. foreclosure proceedings) can eliminate the profit margin on the transaction. In addition, banks need to be mindful that the value of collateral may well be impaired by the same factors that have led to the diminished recoverability of the credit. Banks should have policies covering the acceptability of various forms of collateral, procedures for the ongoing valuation of such collateral, and a process to ensure that collateral is, and continues to be, enforceable and realisable. With regard to guarantees, banks should evaluate the level of coverage being provided in relation to the credit-quality and legal capacity of the guarantor. Banks should be careful when making assumptions about implied support from third parties such as the government.

35. Netting agreements are an important way to reduce credit risks, especially in interbank transactions. In order to actually reduce risk, such agreements need to be sound and legally enforceable.⁷

36. Where actual or potential conflicts of interest exist within the bank, internal confidentiality arrangements (e.g. "Chinese walls") should be established to ensure that there is no hindrance to the bank obtaining all relevant information from the borrower.

Principle 5: Banks should establish overall credit limits at the level of individual borrowers and counterparties, and groups of connected counterparties that aggregate in a comparable and meaningful manner different types of exposures, both in the banking and trading book and on and off the balance sheet.

37. An important element of credit risk management is the establishment of exposure limits on single counterparties and groups of connected counterparties. Such limits are

⁶ Guidance on loan classification and provisioning is available in the document *Sound Practices for Loan Accounting and Disclosure* (July 1999).

⁷ Guidance on netting arrangements is available in the document *Consultative paper on on-balance sheet netting* (April 1998).

frequently based in part on the internal risk rating assigned to the borrower or counterparty, with counterparties assigned better risk ratings having potentially higher exposure limits. Limits should also be established for particular industries or economic sectors, geographic regions and specific products.

38. Exposure limits are needed in all areas of the bank's activities that involve credit risk. These limits help to ensure that the bank's credit-granting activities are adequately diversified. As mentioned earlier, much of the credit exposure faced by some banks comes from activities and instruments in the trading book and off the balance sheet. Limits on such transactions are particularly effective in managing the overall credit risk profile or counterparty risk of a bank. In order to be effective, limits should generally be binding and not driven by customer demand.

39. Effective measures of potential future exposure are essential for the establishment of meaningful limits, placing an upper bound on the overall scale of activity with, and exposure to, a given counterparty, based on a comparable measure of exposure across a bank's various activities (both on and off-balance-sheet).

40. Banks should consider the results of stress testing in the overall limit setting and monitoring process. Such stress testing should take into consideration economic cycles, interest rate and other market movements, and liquidity conditions.

41. Bank's credit limits should recognise and reflect the risks associated with the near-term liquidation of positions in the event of counterparty default.⁸ Where a bank has several transactions with a counterparty, its potential exposure to that counterparty is likely to vary significantly and discontinuously over the maturity over which it is calculated. Potential future exposures should therefore be calculated over multiple time horizons. Limits should also factor in any unsecured exposure in a liquidation scenario.

Principle 6: Banks should have a clearly-established process in place for approving new credits as well as the amendment, renewal and re-financing of existing credits.

42. Many individuals within a bank are involved in the credit-granting process. These include individuals from the business origination function, the credit analysis function and the credit approval function. In addition, the same counterparty may be approaching several different areas of the bank for various forms of credit. Banks may choose to assign responsibilities in different ways; however, it is important that the credit granting process coordinate the efforts of all of the various individuals in order to ensure that sound credit decisions are made.

43. In order to maintain a sound credit portfolio, a bank must have an established formal transaction evaluation and approval process for the granting of credits. Approvals should be made in accordance with the bank's written guidelines and granted by the appropriate level of management. There should be a clear audit trail documenting that the approval process was complied with and identifying the individual(s) and/or committee(s) providing input as well

⁸ Guidance is available in the documents *Banks' Interactions with Highly Leveraged Institutions* and *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* (January 1999).

as making the credit decision. Banks often benefit from the establishment of specialist credit groups to analyse and approve credits related to significant product lines, types of credit facilities and industrial and geographic sectors. Banks should invest in adequate credit decision resources so that they are able to make sound credit decisions consistent with their credit strategy and meet competitive time, pricing and structuring pressures.

44. Each credit proposal should be subject to careful analysis by a qualified credit analyst with expertise commensurate with the size and complexity of the transaction. An effective evaluation process establishes minimum requirements for the information on which the analysis is to be based. There should be policies in place regarding the information and documentation needed to approve new credits, renew existing credits and/or change the terms and conditions of previously approved credits. The information received will be the basis for any internal evaluation or rating assigned to the credit and its accuracy and adequacy is critical to management making appropriate judgements about the acceptability of the credit.

45. Banks must develop a corps of credit risk officers who have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks. A bank's credit-granting approval process should establish accountability for decisions taken and designate who has the absolute authority to approve credits or changes in credit terms. Banks typically utilise a combination of individual signature authority, dual or joint authorities, and a credit approval group or committee, depending upon the size and nature of the credit. Approval authorities should be commensurate with the expertise of the individuals involved.

Principle 7: All extensions of credit must be made on an arm's-length basis. In particular, credits to related companies and individuals must be authorised on an exception basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending.

46. Extensions of credit should be made subject to the criteria and processes described above. These create a system of checks and balances that promote sound credit decisions. Therefore, directors, senior management and other influential parties (e.g. shareholders) should not seek to override the established credit-granting and monitoring processes of the bank.

47. A potential area of abuse arises from granting credit to non-arms-length and related parties, whether companies or individuals.⁹ Consequently, it is important that banks grant credit to such parties on an arm's-length basis and that the amount of credit granted is suitably monitored. Such controls are most easily implemented by requiring that the terms and conditions of such credits not be more favourable than credit granted to non-related borrowers under similar circumstances and by imposing strict absolute limits on such credits. Another possible method of control is the public disclosure of the terms of credits granted to related

⁹ Related parties can include the bank's subsidiaries and affiliates, its major shareholders, directors and senior management, and their direct and related interests, as well as any party that the bank exerts control over or that exerts control over the bank.

parties. The bank's credit-granting criteria should not be altered to accommodate related companies and individuals.

48. Material transactions with related parties should be subject to the approval of the board of directors (excluding board members with conflicts of interest), and in certain circumstances (e.g. a large loan to a major shareholder) reported to the banking supervisory authorities.

IV. Maintaining an Appropriate Credit Administration, Measurement and Monitoring Process

Principle 8: Banks should have in place a system for the ongoing administration of their various credit risk-bearing portfolios.

49. Credit administration is a critical element in maintaining the safety and soundness of a bank. Once a credit is granted, it is the responsibility of the business unit, often in conjunction with a credit administration support team, to ensure that the credit is properly maintained. This includes keeping the credit file up to date, obtaining current financial information, sending out renewal notices and preparing various documents such as loan agreements.

50. Given the wide range of responsibilities of the credit administration function, its organisational structure varies with the size and sophistication of the bank. In larger banks, responsibilities for the various components of credit administration are usually assigned to different departments. In smaller banks, a few individuals might handle several of the functional areas. Where individuals perform such sensitive functions as custody of key documents, wiring out funds, or entering limits into the computer database, they should report to managers who are independent of the business origination and credit approval processes.

51. In developing their credit administration areas, banks should ensure:

- the efficiency and effectiveness of credit administration operations, including monitoring documentation, contractual requirements, legal covenants, collateral, etc.;
- the accuracy and timeliness of information provided to management information systems;
- adequate segregation of duties;
- the adequacy of controls over all "back office" procedures; and
- compliance with prescribed management policies and procedures as well as applicable laws and regulations.

52. For the various components of credit administration to function appropriately, senior management must understand and demonstrate that it recognises the importance of this element of monitoring and controlling credit risk.

53. The credit files should include all of the information necessary to ascertain the current financial condition of the borrower or counterparty as well as sufficient information to track the decisions made and the history of the credit. For example, the credit files should include current financial statements, financial analyses and internal rating documentation, internal memoranda, reference letters, and appraisals. The loan review function should determine that the credit files are complete and that all loan approvals and other necessary documents have been obtained.

Principle 9: Banks must have in place a system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves.

54. Banks need to develop and implement comprehensive procedures and information systems to monitor the condition of individual credits and single obligors across the bank's various portfolios. These procedures need to define criteria for identifying and reporting potential problem credits and other transactions to ensure that they are subject to more frequent monitoring as well as possible corrective action, classification and/or provisioning.¹⁰

55. An effective credit monitoring system will include measures to:

- ensure that the bank understands the current financial condition of the borrower or counterparty;
- monitor compliance with existing covenants;
- assess, where applicable, collateral coverage relative to the obligor's current condition;
- identify contractual payment delinquencies and classify potential problem credits on a timely basis; and
- direct promptly problems for remedial management.

56. Specific individuals should be responsible for monitoring credit quality, including ensuring that relevant information is passed to those responsible for assigning internal risk ratings to the credit. In addition, individuals should be made responsible for monitoring on an ongoing basis any underlying collateral and guarantees. Such monitoring will assist the bank in making necessary changes to contractual arrangements as well as maintaining adequate reserves for credit losses. In assigning these responsibilities, bank management should recognise the potential for conflicts of interest, especially for personnel who are judged and rewarded on such indicators as loan volume, portfolio quality or short-term profitability.

Principle 10: Banks are encouraged to develop and utilise an internal risk rating system in managing credit risk. The rating system should be consistent with the nature, size and complexity of a bank's activities.

¹⁰ See footnote 6.

57. An important tool in monitoring the quality of individual credits, as well as the total portfolio, is the use of an internal risk rating system. A well-structured internal risk rating system is a good means of differentiating the degree of credit risk in the different credit exposures of a bank. This will allow more accurate determination of the overall characteristics of the credit portfolio, concentrations, problem credits, and the adequacy of loan loss reserves. More detailed and sophisticated internal risk rating systems, used primarily at larger banks, can also be used to determine internal capital allocation, pricing of credits, and profitability of transactions and relationships.

58. Typically, an internal risk rating system categorises credits into various classes designed to take into account gradations in risk. Simpler systems might be based on several categories ranging from satisfactory to unsatisfactory; however, more meaningful systems will have numerous gradations for credits considered satisfactory in order to truly differentiate the relative credit risk they pose. In developing their systems, banks must decide whether to rate the riskiness of the borrower or counterparty, the risks associated with a specific transaction, or both.

59. Internal risk ratings are an important tool in monitoring and controlling credit risk. In order to facilitate early identification of changes in risk profiles, the bank's internal risk rating system should be responsive to indicators of potential or actual deterioration in credit risk. Credits with deteriorating ratings should be subject to additional oversight and monitoring, for example, through more frequent visits from credit officers and inclusion on a watchlist that is regularly reviewed by senior management. The internal risk ratings can be used by line management in different departments to track the current characteristics of the credit portfolio and help determine necessary changes to the credit strategy of the bank. Consequently, it is important that the board of directors and senior management also receive periodic reports on the condition of the credit portfolios based on such ratings.

60. The ratings assigned to individual borrowers or counterparties at the time the credit is granted must be reviewed on a periodic basis and individual credits should be assigned a new rating when conditions either improve or deteriorate. Because of the importance of ensuring that internal ratings are consistent and accurately reflect the quality of individual credits, responsibility for setting or confirming such ratings should rest with a credit review function independent of that which originated the credit concerned. It is also important that the consistency and accuracy of ratings is examined periodically by a function such as an independent credit review group.

Principle 11: Banks must have information systems and analytical techniques that enable management to measure the credit risk inherent in all on- and off-balance sheet activities. The management information system should provide adequate information on the composition of the credit portfolio, including identification of any concentrations of risk.

61. Banks should have methodologies that enable them to quantify the risk involved in exposures to individual borrowers or counterparties. Banks should also be able to analyse credit risk at the product and portfolio level in order to identify any particular sensitivities or concentrations. The measurement of credit risk should take account of (i) the specific nature of the credit (loan, derivative, facility, etc.) and its contractual and financial conditions (maturity, reference rate, etc.); (ii) the exposure profile until maturity in relation to potential market movements; (iii) the existence of collateral or guarantees; and (iv) the potential for default based on the internal risk rating. The analysis of credit risk data should be undertaken

at an appropriate frequency with the results reviewed against relevant limits. Banks should use measurement techniques that are appropriate to the complexity and level of the risks involved in their activities, based on robust data, and subject to periodic validation.

62. The effectiveness of a bank's credit risk measurement process is highly dependent on the quality of management information systems. The information generated from such systems enables the board and all levels of management to fulfil their respective oversight roles, including determining the adequate level of capital that the bank should be holding. Therefore, the quality, detail and timeliness of information are critical. In particular, information on the composition and quality of the various portfolios, including on a consolidated bank basis, should permit management to assess quickly and accurately the level of credit risk that the bank has incurred through its various activities and determine whether the bank's performance is meeting the credit risk strategy.

63. Banks should monitor actual exposures against established limits. It is important that banks have a management information system in place to ensure that exposures approaching risk limits are brought to the attention of senior management. All exposures should be included in a risk limit measurement system. The bank's information system should be able to aggregate credit exposures to individual borrowers and counterparties and report on exceptions to credit risk limits on a meaningful and timely basis.

64. Banks should have information systems in place that enable management to identify any concentrations of risk within the credit portfolio. The adequacy of scope of information should be reviewed on a periodic basis by business line managers and senior management to ensure that it is sufficient to the complexity of the business. Increasingly, banks are also designing information systems that permit additional analysis of the credit portfolio, including stress testing.

Principle 12: Banks must have in place a system for monitoring the overall composition and quality of the credit portfolio.

65. Traditionally, banks have focused on oversight of contractual performance of individual credits in managing their overall credit risk. While this focus is important, banks also need to have in place a system for monitoring the overall composition and quality of the various credit portfolios. This system should be consistent with the nature, size and complexity of the bank's portfolios.

66. A continuing source of credit-related problems in banks is concentrations within the credit portfolio. Concentrations of risk can take many forms and can arise whenever a significant number of credits have similar risk characteristics. Concentrations occur when, among other things, a bank's portfolio contains a high level of direct or indirect credits to (i) a single counterparty, (ii) a group of connected counterparties¹¹, (iii) a particular industry or economic sector, (iv) a geographic region, (v) an individual foreign country or a group of countries whose economies are strongly interrelated, (vi) a type of credit facility, or (vii) a type of collateral. Concentrations also occur in credits with the same maturity. Concentrations can stem from more complex or subtle linkages among credits in the portfolio. The

¹¹ See footnote 5.

concentration of risk does not only apply to the granting of loans but to the whole range of banking activities that, by their nature, involve counterparty risk. A high level of concentration exposes the bank to adverse changes in the area in which the credits are concentrated.

67. In many instances, due to a bank's trade area, geographic location or lack of access to economically diverse borrowers or counterparties, avoiding or reducing concentrations may be extremely difficult. In addition, banks may want to capitalise on their expertise in a particular industry or economic sector. A bank may also determine that it is being adequately compensated for incurring certain concentrations of risk. Consequently, banks should not necessarily forego booking sound credits solely on the basis of concentration. Banks may need to make use of alternatives to reduce or mitigate concentrations. Such measures can include pricing for the additional risk, increased holdings of capital to compensate for the additional risks and making use of loan participations in order to reduce dependency on a particular sector of the economy or group of related borrowers. Banks must be careful not to enter into transactions with borrowers or counterparties they do not know or engage in credit activities they do not fully understand simply for the sake of diversification.

68. Banks have new possibilities to manage credit concentrations and other portfolio issues. These include such mechanisms as loan sales, credit derivatives, securitisation programs and other secondary loan markets. However, mechanisms to deal with portfolio concentration issues involve risks that must also be identified and managed. Consequently, when banks decide to utilise these mechanisms, they need to first have policies and procedures, as well as adequate controls, in place.

Principle 13: Banks should take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressful conditions.

69. An important element of sound credit risk management involves discussing what could potentially go wrong with individual credits and within the various credit portfolios, and factoring this information into the analysis of the adequacy of capital and provisions. This "what if" exercise can reveal previously undetected areas of potential credit risk exposure for the bank. The linkages between different categories of risk that are likely to emerge in times of crisis should be fully understood. In case of adverse circumstances, there may be a substantial correlation of various risks, especially credit and market risk. Scenario analysis and stress testing are useful ways of assessing areas of potential problems.

70. Stress testing should involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a bank's credit exposures and assessing the bank's ability to withstand such changes. Three areas that banks could usefully examine are: (i) economic or industry downturns; (ii) market-risk events; and (iii) liquidity conditions. Stress testing can range from relatively simple alterations in assumptions about one or more financial, structural or economic variables to the use of highly sophisticated financial models. Typically, the latter are used by large, internationally active banks.

71. Whatever the method of stress testing used, the output of the tests should be reviewed periodically by senior management and appropriate action taken in cases where the results exceed agreed tolerances. The output should also be incorporated into the process for assigning and updating policies and limits.

72. The bank should attempt to identify the types of situations, such as economic downturns, both in the whole economy or in particular sectors, higher than expected levels of delinquencies and defaults, or the combinations of credit and market events, that could produce substantial losses or liquidity problems. Such an analysis should be done on a consolidated bank basis. Stress-test analyses should also include contingency plans regarding actions management might take given certain scenarios. These can include such techniques as hedging against the outcome or reducing the size of the exposure.

V. Ensuring Adequate Controls over Credit Risk

Principle 14: Banks must establish a system of independent, ongoing assessment of the bank's credit risk management processes and the results of such reviews should be communicated directly to the board of directors and senior management.

73. Because various appointed individuals throughout a bank have the authority to grant credit, the bank should have an efficient internal review and reporting system in order to manage effectively the bank's various portfolios. This system should provide the board of directors and senior management with sufficient information to evaluate the performance of account officers and the condition of the credit portfolio.

74. Internal credit reviews conducted by individuals independent from the business function provide an important assessment of individual credits and the overall quality of the credit portfolio. Such a credit review function can help evaluate the overall credit administration process, determine the accuracy of internal risk ratings and judge whether the account officer is properly monitoring individual credits. The credit review function should report directly to the board of directors, a committee with audit responsibilities, or senior management without lending authority (e.g., senior management within the risk control function).

Principle 15: Banks must ensure that the credit-granting function is being properly managed and that credit exposures are within levels consistent with prudential standards and internal limits. Banks should establish and enforce internal controls and other practices to ensure that exceptions to policies, procedures and limits are reported in a timely manner to the appropriate level of management for action.

75. The goal of credit risk management is to maintain a bank's credit risk exposure within parameters set by the board of directors and senior management. The establishment and enforcement of internal controls, operating limits and other practices will help ensure that credit risk exposures do not exceed levels acceptable to the individual bank. Such a system will enable bank management to monitor adherence to the established credit risk objectives.

76. Limit systems should ensure that granting of credit exceeding certain predetermined levels receive prompt management attention. An appropriate limit system should assist management in controlling credit risk exposures, initiating discussion about opportunities and risks, and monitoring actual risk taking against predetermined credit risk tolerances.

77. Internal audits of the credit risk processes should be conducted on a periodic basis to determine that credit activities are in compliance with the bank's credit policies and procedures, that credits are authorised within the guidelines established by the bank's board of

directors and that the existence, quality and value of individual credits are accurately being reported to senior management. Such audits should also be used to identify areas of weakness in the credit risk management process, policies and procedures as well as any exceptions to policies, procedures and limits.

Principle 16: Banks must have a system in place for early remedial action on deteriorating credits, managing problem credits and similar workout situations.

78. One reason for establishing a systematic credit review process is to identify weakened or problem credits.¹² A reduction in credit quality should be recognised at an early stage when there may be more options available for improving the credit. Banks must have a disciplined and vigorous remedial management process, triggered by specific events, that is administered through the credit administration and problem recognition systems.

79. A bank's credit risk policies should clearly set out how the bank will manage problem credits. Banks differ on the methods and organisation they use to manage problem credits. Responsibility for such credits may be assigned to the originating business function, a specialised workout section, or a combination of the two, depending upon the size and nature of the credit and the reason for its problems.

80. Effective workout programs are critical to managing risk in the portfolio. When a bank has significant credit-related problems, it is important to segregate the workout function from the area that originated the credit. The additional resources, expertise and more concentrated focus of a specialised workout section normally improve collection results. A workout section can help develop an effective strategy to rehabilitate a troubled credit or to increase the amount of repayment ultimately collected. An experienced workout section can also provide valuable input into any credit restructurings organised by the business function.

VI. The Role of Supervisors

Principle 17: Supervisors should require that banks have an effective system in place to identify, measure, monitor and control credit risk as part of an overall approach to risk management. Supervisors should conduct an independent evaluation of a bank's strategies, policies, procedures and practices related to the granting of credit and the ongoing management of the portfolio. Supervisors should consider setting prudential limits to restrict bank exposures to single borrowers or groups of connected counterparties.

81. Although the board of directors and senior management bear the ultimate responsibility for an effective system of credit risk management, supervisors should, as part of their ongoing supervisory activities, assess the system in place at individual banks to identify, measure, monitor and control credit risk. This should include an assessment of any measurement tools (such as internal risk ratings and credit risk models) used by the bank. In addition, they should determine that the board of directors effectively oversees the credit risk

¹² See footnote 6.

management process of the bank and that management monitors risk positions, and compliance with and appropriateness of policies.

82. To evaluate the quality of credit risk management systems, supervisors can take a number of approaches. A key element in such an evaluation is the determination by supervisors that the bank is utilising sound asset valuation procedures. Most typically, supervisors, or the external auditors on whose work they partially rely, conduct a review of the quality of a sample of individual credits. In those instances where the supervisory analysis agrees with the internal analysis conducted by the bank, a higher degree of dependence can be placed on the use of such internal reviews for assessing the overall quality of the credit portfolio and the adequacy of provisions and reserves¹³. Supervisors or external auditors should also assess the quality of a bank's own internal validation process where internal risk ratings and/or credit risk models are used. Supervisors should also review the results of any independent internal reviews of the credit-granting and credit administration functions. Supervisors should also make use of any reviews conducted by the bank's external auditors, where available.

83. Supervisors should take particular note of whether bank management recognises problem credits at an early stage and takes the appropriate actions.¹⁴ Supervisors should monitor trends within a bank's overall credit portfolio and discuss with senior management any marked deterioration. Supervisors should also assess whether the capital of the bank, in addition to its provisions and reserves, is adequate related to the level of credit risk identified and inherent in the bank's various on- and off-balance sheet activities.

84. In reviewing the adequacy of the credit risk management process, home country supervisors should also determine that the process is effective across business lines, subsidiaries and national boundaries. It is important that supervisors evaluate the credit risk management system not only at the level of individual businesses or legal entities but also across the wide spectrum of activities and subsidiaries within the consolidated banking organisation.

85. After the credit risk management process is evaluated, the supervisors should address with management any weaknesses detected in the system, excess concentrations, the classification of problem credits and the estimation of any additional provisions and the effect on the bank's profitability of any suspension of interest accruals. In those instances where supervisors determine that a bank's overall credit risk management system is not adequate or effective for that bank's specific credit risk profile, they should ensure the bank takes the appropriate actions to improve promptly its credit risk management process.

86. Supervisors should consider setting prudential limits (e.g., large exposure limits) that would apply to all banks, irrespective of the quality of their credit risk management process. Such limits would include restricting bank exposures to single borrowers or groups of

¹³ The New Capital Adequacy Framework anticipates that, subject to supervisory approval, banks' internal rating methodologies may be used as a basis for regulatory capital calculation. Guidance to supervisors specific to this purpose will be published in due course.

¹⁴ See footnote 6.

connected counterparties. Supervisors may also want to impose certain reporting requirements for credits of a particular type or exceeding certain established levels. In particular, special attention needs to be paid to credits granted to counterparties “connected” to the bank, or to each other.

Appendix

Common Sources of Major Credit Problems

1. Most major banking problems have been either explicitly or indirectly caused by weaknesses in credit risk management. In supervisors' experience, certain key problems tend to recur. Severe credit losses in a banking system usually reflect simultaneous problems in several areas, such as concentrations, failures of due diligence and inadequate monitoring. This appendix summarises some of the most common problems related to the broad areas of concentrations, credit processing, and market- and liquidity-sensitive credit exposures.

Concentrations

2. Concentrations are probably the single most important cause of major credit problems. Credit concentrations are viewed as any exposure where the potential losses are large relative to the bank's capital, its total assets or, where adequate measures exist, the bank's overall risk level. Relatively large losses¹⁵ may reflect not only **large exposures**, but also the potential for **unusually high percentage losses given default**.

3. Credit concentrations can further be grouped roughly into two categories:

- **Conventional credit concentrations** would include concentrations of credits to single borrowers or counterparties, a group of connected counterparties, and sectors or industries, such as commercial real estate, and oil and gas.
- **Concentrations based on common or correlated risk factors** reflect subtler or more situation-specific factors, and often can only be uncovered through analysis. Disturbances in Asia and Russia in late 1998 illustrate how close linkages among emerging markets under stress conditions and previously undetected correlations between market and credit risks, as well as between those risks and liquidity risk, can produce widespread losses.

4. Examples of concentrations based on the potential for unusually deep losses often embody factors such as leverage, optionality, correlation of risk factors and structured financings that concentrate risk in certain tranches. For example, a highly leveraged borrower will likely produce larger credit losses for a given severe price or economic shock than a less leveraged borrower whose capital can absorb a significant portion of any loss. The onset of exchange rate devaluations in late 1997 in Asia revealed the correlation between exchange rate devaluation and declines in financial condition of foreign exchange derivative counterparties resident in the devaluing country, producing very substantial losses relative to notional amounts of those derivatives. The risk in a pool of assets can be concentrated in a

¹⁵ Losses are equal to the exposure times the percentage loss given the event of default.

securitisation into subordinated tranches and claims on leveraged special purpose vehicles, which in a downturn would suffer substantial losses.

5. The recurrent nature of credit concentration problems, especially involving conventional credit concentrations, raises the issue of why banks allow concentrations to develop. First, in developing their business strategy, most banks face an inherent trade-off between choosing to specialise in a few key areas with the goal of achieving a market leadership position and diversifying their income streams, especially when they are engaged in some volatile market segments. This trade-off has been exacerbated by intensified competition among banks and non-banks alike for traditional banking activities, such as providing credit to investment grade corporations. Concentrations appear most frequently to arise because banks identify “hot” and rapidly growing industries and use overly optimistic assumptions about an industry’s future prospects, especially asset appreciation and the potential to earn above-average fees and/or spreads. Banks seem most susceptible to overlooking the dangers in such situations when they are focused on asset growth or market share.

6. Banking supervisors should have specific regulations limiting concentrations to one borrower or set of related borrowers, and, in fact, should also expect banks to set much lower limits on single-obligor exposure. Most credit risk managers in banks also monitor industry concentrations. Many banks are exploring techniques to identify concentrations based on common risk factors or correlations among factors. While small banks may find it difficult not to be at or near limits on concentrations, very large banking organisations must recognise that, because of their large capital base, their exposures to single obligors can reach imprudent levels while remaining within regulatory limits.

Credit Process Issues

7. Many credit problems reveal basic weaknesses in the credit granting and monitoring processes. While shortcomings in underwriting and management of market-related credit exposures represent important sources of losses at banks, many credit problems would have been avoided or mitigated by a strong internal credit process.

8. Many banks find carrying out a **thorough credit assessment** (or basic due diligence) a substantial challenge. For traditional bank lending, competitive pressures and the growth of loan syndication techniques create time constraints that interfere with basic due diligence. Globalisation of credit markets increases the need for financial information based on sound accounting standards and timely macroeconomic and flow of funds data. When this information is not available or reliable, banks may dispense with financial and economic analysis and support credit decisions with simple indicators of credit quality, especially if they perceive a need to gain a competitive foothold in a rapidly growing foreign market. Finally, banks may need new types of information, such as risk measurements, and more frequent financial information, to assess relatively newer counterparties, such as institutional investors and highly leveraged institutions.

9. The absence of **testing and validation of new lending techniques** is another important problem. Adoption of untested lending techniques in new or innovative areas of the market, especially techniques that dispense with sound principles of due diligence or traditional benchmarks for leverage, have led to serious problems at many banks. Sound practice calls for the application of basic principles to new types of credit activity. Any new

technique involves uncertainty about its effectiveness. That uncertainty should be reflected in somewhat greater conservatism and corroborating indicators of credit quality. An example of the problem is the expanded use of credit-scoring models in consumer lending in the United States and some other countries. Large credit losses experienced by some banks for particular tranches of certain mass-marketed products indicates the potential for scoring weaknesses.

10. Some credit problems arise from **subjective decision-making by senior management** of the bank. This includes extending credits to companies they own or with which they are affiliated, to personal friends, to persons with a reputation for financial acumen or to meet a personal agenda, such as cultivating special relationships with celebrities.

11. Many banks that experienced asset quality problems in the 1990s lacked an **effective credit review process** (and indeed, many banks had no credit review function). Credit review at larger banks usually is a department made up of analysts, independent of the lending officers, who make an independent assessment of the quality of a credit or a credit relationship based on documentation such as financial statements, credit analysis provided by the account officer and collateral appraisals. At smaller banks, this function may be more limited and performed by internal or external auditors. The purpose of credit review is to provide appropriate checks and balances to ensure that credits are made in accordance with bank policy and to provide an independent judgement of asset quality, uninfluenced by relationships with the borrower. Effective credit review not only helps to detect poorly underwritten credits, it also helps prevent weak credits from being granted, since credit officers are likely to be more diligent if they know their work will be subject to review.

12. A common and very important problem among troubled banks in the early 1990s was their failure to **monitor borrowers or collateral values**. Many banks neglected to obtain periodic financial information from borrowers or real estate appraisals in order to evaluate the quality of loans on their books and the adequacy of collateral. As a result, many banks failed to recognise early signs that asset quality was deteriorating and missed opportunities to work with borrowers to stem their financial deterioration and to protect the bank's position. This lack of monitoring led to a costly process by senior management to determine the dimension and severity of the problem loans and resulted in large losses.

13. In some cases, the failure to perform adequate due diligence and financial analysis and to monitor the borrower can result in a breakdown of **controls to detect credit-related fraud**. For example, banks experiencing fraud-related losses have neglected to inspect collateral, such as goods in a warehouse or on a showroom floor, have not authenticated or valued financial assets presented as collateral, or have not required audited financial statements and carefully analysed them. An effective credit review department and independent collateral appraisals are important protective measures, especially to ensure that credit officers and other insiders are not colluding with borrowers.

14. In addition to shortcomings in due diligence and credit analysis, bank credit problems reflect other recurring problems in credit-granting decisions. Some banks analyse credits and decide on appropriate non-price credit terms, but do not use **risk-sensitive pricing**. Banks that lack a sound pricing methodology and the discipline to follow consistently such a methodology will tend to attract a disproportionate share of under-priced risks. These banks will be increasingly disadvantaged relative to banks that have superior pricing skills.

15. Many banks have experienced credit losses because of the failure to use sufficient **caution with certain leveraged credit arrangements**. As noted above, credit extended to highly leveraged borrowers is likely to have large losses in default. Similarly, leveraged structures such as some buyout or debt restructuring strategies, or structures involving customer-written options, generally introduce concentrated credit risks into the bank's credit portfolio and should only be used with financially strong customers. Often, however, such structures are most appealing to weaker borrowers because the financing enables a substantial upside gain if all goes well, while the borrower's losses are limited to its net worth.

16. Many banks' credit activities involve **lending against non-financial assets**. In such lending, many banks have failed to make an adequate assessment of the correlation between the financial condition of the borrower and the price changes and liquidity of the market for the collateral assets. Much asset-based business lending (i.e. commercial finance, equipment leasing, and factoring) and commercial real estate lending appear to involve a relatively high correlation between borrower creditworthiness and asset values. Since the borrower's income, the principal source of repayment, is generally tied to the assets in question, deterioration in the borrower's income stream, if due to industry or regional economic problems, may be accompanied by declines in asset values for the collateral. Some asset based consumer lending (i.e. home equity loans, auto financing) exhibits a similar, if weaker, relationship between the financial health of consumers and the markets for consumer assets.

17. A related problem is that many banks do not take **sufficient account of business cycle effects** in lending. As income prospects and asset values rise in the ascending portion of the business cycle, credit analysis may incorporate overly optimistic assumptions. Industries such as retailing, commercial real estate and real estate investment trusts, utilities, and consumer lending often experience strong cyclical effects. Sometimes the cycle is less related to general business conditions than the product cycle in a relatively new, rapidly growing sector, such as health care and telecommunications. Effective stress testing which takes account of business or product cycle effects is one approach to incorporating into credit decisions a fuller understanding of a borrower's credit risk.

18. More generally, many underwriting problems reflect the absence of a **thoughtful consideration of downside scenarios**. In addition to the business cycle, borrowers may be vulnerable to changes in risk factors such as specific commodity prices, shifts in the competitive landscape and the uncertainty of success in business strategy or management direction. Many lenders fail to "stress test" or analyse the credit using sufficiently adverse assumptions and thus fail to detect vulnerabilities.

Market and Liquidity-Sensitive Credit Exposures

19. Market and liquidity-sensitive exposures pose special challenges to the credit processes at banks. Market-sensitive exposures include foreign exchange and financial derivative contracts. Liquidity-sensitive exposures include margin and collateral agreements with periodic margin calls, liquidity back-up lines, commitments and some letters of credit, and some unwind provisions of securitisations. The contingent nature of the exposure in these instruments requires the bank to have the ability to assess the probability distribution of the size of actual exposure in the future and its impact on both the borrower's and the bank's leverage and liquidity.

20. An issue faced by virtually all financial institutions is the need to develop **meaningful measures of exposure** that can be compared readily with loans and other credit exposures. This problem is described at some length in the Basel Committee's January 1999 study of exposures to highly leveraged institutions.¹⁶

21. Market-sensitive instruments require a **careful analysis of the customer's willingness and ability to pay**. Most market-sensitive instruments, such as financial derivatives, are viewed as relatively sophisticated instruments, requiring some effort by both the bank and the customer to ensure that the contract is well understood by the customer. The link to changes in asset prices in financial markets means that the value of such instruments can change very sharply and adversely to the customer, usually with a small, but non-zero probability. Effective stress testing can reveal the potential for large losses, which sound practice suggests should be disclosed to the customer. Banks have suffered significant losses when they have taken insufficient care to ensure that the customer fully understood the transaction at origination and subsequent large adverse price movements left the customer owing the bank a substantial amount.

22. Liquidity-sensitive credit arrangements or instruments require a **careful analysis of the customer's vulnerability to liquidity stresses**, since the bank's funded credit exposure can grow rapidly when customers are subject to such stresses. Such increased pressure to have sufficient liquidity to meet margin agreements supporting over-the-counter trading activities or clearing and settlement arrangements may directly reflect market price volatility. In other instances, liquidity pressures in the financial system may reflect credit concerns and a constricting of normal credit activity, leading borrowers to utilise liquidity backup lines or commitments. Liquidity pressures can also be the result of inadequate liquidity risk management by the customer or a decline in its creditworthiness, making an assessment of a borrower's or counterparty's liquidity risk profile another important element of credit analysis.

23. Market- and liquidity-sensitive instruments change in riskiness with changes in the underlying distribution of price changes and market conditions. For market-sensitive instruments, for example, increases in the volatility of price changes effectively increases potential exposures. Consequently, banks should conduct **stress testing of volatility assumptions**.

24. Market- and liquidity-sensitive exposures, because they are probabilistic, can be correlated with the creditworthiness of the borrower. This is an important insight gained from the market turmoil in Asia, Russia and elsewhere in the course of 1997 and 1998. That is, the same factor that changes the value of a market- or liquidity-sensitive instrument can also influence the borrower's financial health and future prospects. Banks need to **analyse the relationship between market- and liquidity-sensitive exposures and the default risk of the borrower**. Stress testing — shocking the market or liquidity factors — is a key element of that analysis.

¹⁶ See *Banks' Interactions with Highly Leveraged Institutions* and *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* (January 1999).

Credit Risk Grading

Developed by:
Keith Checkley FCIB
And Keith Dickinson FCIB

© Keith Checkley & Associates

1

Welcome:

- Introduction to Module
- Technical Instructions for Participating
 - With all our content on-demand; you choose when to start, stop or pause the presentation

2

What is Credit Risk?

- **Credit Risk can be defined as**
the Credit Loss emanating from a Borrower or Counterparty failing to meet their obligation in accordance with the agreed terms.

3

The Importance of Credit

- Prudent management of the Financial Institution is a reflection of its ability to balance successfully the risk in the portfolio with profit earned on it
- The fundamental purpose of credit risk management is to develop 'good' business with:
 - a known and acceptable level of risk
 - appropriate controls to mitigate the risk
 - an acceptable return

4

The Importance of Credit continued

- The primary vision when writing policy is to determine the institution's tolerance for accepting financial risks and articulate it when defining the risk parameters of the policy.
- Each financial institution is unique and this must be reflected in its policy.
- The policy must reflect the collective risk tolerance of senior managers and boards of directors, which may vary from extremely conservative to very aggressive.

5

The Importance of Credit continued

- The Credit Risk Committee policy must also address the responsibility for managing the institution's capital position. If Credit risk wants to establish strong control of the risk position, it should include a description of its minimum default expectations within the policy.
- When developing controls the Credit Committee will need to set sectorial and business exposure limits to mitigate economic downturn sectorial risks
- The frequency that accounts will be monitored and the establishment of credit grade guidelines to manage the mix of lending will enhance portfolio management.

6

RISK MANAGEMENT - BIS

- It's sub-committee, Basle Committee on Banking Supervision, Basle, is one which encourages banking supervisors globally to promote sound practices for managing risk.
- Their consultative document 'Principles for the Management of Credit Risk' discusses principles applicable to the business of lending.----ref www.bis.org.---2002.

7

RISK MANAGEMENT – BIS

Standards-17 Key Principles

The main topics of the Basle Paper are:

- Establishing an Appropriate Credit Risk Environment
- Operating under a Sound Credit Granting Process
- Maintaining an Appropriate Credit Administration,
Measurement and Monitoring Process
- Ensuring Adequate Controls over Credit Risk

8

Basel Extract:

- Principle 10: Banks are encouraged to develop and utilise an internal risk rating system in managing credit risk. The rating system should be consistent with the nature, size and complexity of a bank's activities.
- An important tool in monitoring the quality of individual credits, as well as the total portfolio, is the use of an internal risk rating system.
- A well-structured internal risk rating system is a good means of differentiating the degree of credit risk in the different credit exposures of a bank.

9

Basel Extract: *continued*

- This will allow more accurate determination of the overall characteristics of the credit portfolio, concentrations, problem credits, and the adequacy of loan loss reserves.
- More detailed and sophisticated internal risk rating systems, used primarily at larger banks, can also be used to determine internal capital allocation, pricing of credits, and profitability of transactions and relationships.

10

Credit Risk Rating Systems

Objectives for Control:

- Assist with overall portfolio management by identifying and monitoring risk composition
- Individual account management, which is proactive to problem causes and symptoms rather than reactive to default/collapse

11

Credit Risk Rating Systems

Main Benefits:

- **“Macro”** - More informed strategic decision making through identification of opportunities/threats within the loan portfolio
- **“Micro”** - Early warning of potential problems followed by prompt action will reduce loan losses

12

Credit Risk Rating Systems

Requirements:

- Universally understood and applied consistently
- Minimum number of categories which are easily defined
- Standardised and streamlined reporting procedures which ensure: accuracy, clarity and brevity
- Individual ownership and responsibility for problem accounts
- Every problem account to have an action plan and strategy in place

13

Example of Account Risk Rating Categories

<u>Rating</u>	<u>Official Definition</u>	<u>Unofficial Term(s)</u>
1A	Highest Quality	“AAA”/Blue Chip/ Undoubted
1B	Very Strong	Highly valued/First Class Track Record
2	Fully Satisfactory	Solid Performer/No previous problems and none expected

14

Example of Account Risk Rating Categories

Rating	Official Definition	Unofficial Term(s)
3	Minor Weaknesses	Should be OK, put on Watch List
4	Weak	Possible Loss
5	Partial Loss	Without major upturn in fortunes, bank will lose money, provision needed
6	Full Loss	Collapse/Full provision needed

15

What is Credit Rating ?

- Credit Rating can be defined as *the measuring of credit risk through a combination of quantitative and qualitative factors applying judgmental factors based on experience.*
- *It is therefore not an exact science.*

© Keith Checkley & Associates

16

Credit Risk Rating

Main Segments to consider:

- Micro Finance
- Personal Lending
- SME Businesses
- Corporates
- Project Finance

17

Micro Finance

A Definition:

“The Provision of Financial Services to Low-Income Clients, including Consumers and the Self-Employed.”

18

Micro Finance **continued**

The aim of Microfinance:

- To help raise Income
- To help build up Assets
- To help cushion against External Shocks.

Micro financial Services are needed everywhere – including the developed World.

19

Micro Finance **continued**

The Problems in this Marketplace:

- Clients with little or no cash Income.
- The Cost of providing Banking Services to this Market.
- Few Assets available to use as Collateral.

Hence we have seen the development of specialised Micro Finance Institutions - who can undertake financing to this special sector - see handout in study pack.

20

Personal Lending - Ratings : Measuring Probability of Default (PD)

- PD is a widely understood component or risk within retail banking. Most consumer credit scorecards that exist within retail banking have been developed to measure PD.
- If an organisation does not have application and behavioural scorecards, a significant amount of work will be required to develop these.
- The model development process is similar for both of these areas, though each type of scorecard development has its own anomalies.
- PD is the most important component of risk modelling for unsecured products, and it is a significant driver in the risk calculations for all lending products.

21

Scorecard development

The kind of data used within application scorecards varies widely, but generally anything on the credit application form can be included in an application scorecard, not withstanding any local data protection or anti-discriminatory laws.

22

Application Scorecard development

Some typical fields that are used in application score development are listed below:

- Age, Sex, Marital status
- Educational qualifications
- Residential status (e.g. homeowner, living with parents etc)
- Length of time at current address
- Industry in which the applicant works
- Job position (e.g. director, manager, team worker etc)
- Length of time in current job
- Current banking products utilised
- Length of time bank account held

- These fields are known as a “characteristics” in model development

23

An Example Application Scorecard

Weight	Variable Description
250	
-13	Accommodation Type = "Rented"
57	Accommodation Type = "Home Owner"
-27	Age < 23 years
-7	Age = 23-42 years
55	Education level = MBA
41	Education level = Masters/doctorate
18	Education level = Degree
-81	Occupation = High Risk
-37	Occupation = Medium Risk
26	Sex = Female
-42	Years in current job <3 years
-60	Time at current address <4 years
52	Time at current address >7 years

24

Scorecards

Data that can be included within BEHAVIORAL scorecards can include any of the following:

- Balance data
- Credit Limit information (generally only including agreed limit, as the other limits are beyond the customer's control)
- Utilisation information
- Transactions (including use of ATMs, cards as payment mechanism, standing orders, direct debits etc.)
- Fees (Late payment fees, over-limit fees etc)
- Payments (cash payments into the account, cheque payments, automated payments)

25

Small and Medium Enterprises – Ratings

Definition: Small and Medium Enterprises (SME) are either self-employed people or small firms, with sales typically in the single or tens of thousands/millions euros, which are typically regional in focus.

The following data can be used for a rating tool for SMEs:

- Spread of financial statement
- Current account information
- Information about management strategies
- Industry reviews, regional reviews and external assessment of market position

26

Small and Medium Enterprises

- For SME portfolios, we differentiate hard facts and soft facts as top-level classification of available data. Information sectors are further differentiated by source or content of information:

- **Hard Facts:**

Financial Statements, Account Data, Regional Data and Industry Sector Data

- **Soft Facts:**

Management Evaluation, Market Evaluation, SWOT (Strengths, weaknesses, opportunities and threats) and Balance Sheet Forecasts and Scenarios.

27

Small and Medium Enterprises

Hybrid System

- A reliable estimate of the default probability of a customer or applicant should be based on data from different information sectors – financial (balance sheet) information, account data, external credit bureau data and so on.
- Technical and maintenance requirements are such, that it is often helpful to develop separate score functions for each information sector and to combine the resulting scores into a final default probability estimate.
- This modular approach can also improve the transparency and acceptability of the score system.

28

Small and Medium Enterprises

- Example: For SME portfolios a standard process is the combination of financial statement rating, behaviour score and qualitative evaluation of market and management evaluation by the analyst.

- All results of the sub-modules are translated into a probability of default estimate for combination.

- The main issue will be the “weighting” given to the financial factors versus the non-financial factors

For example where the financials are robust and reliable a weighting of 60/40 could be made or vice versa.

© Keith Checkley & Associates

29

SME – Financial Statement rating

- Financial statement information is spread into the internal database either manually by the analyst or using interfaces to external data providers.
- Within the module, customers are segmented into a small number of industry sectors and sales volume categories.
- This allows optimisation with regard to industry – and size specific financial statement ratios.
- The methodology applied might be a linear discriminant analysis. Ratios include evaluations of the balance sheet structure, the profit-and-loss and the cash-flow situation.

30

SME – Behaviour Score based on Account Data

- Account data is important up-to-date information on the customer. They are usually of good quality and available electronically.
- A behaviour score should be based on ratios generated by the variables describing all aspects necessary for account management, e.g. account balance information, turnover, utilisation, overdrafts.

31

SME – Rating Sheet for “Market and Competition”

- For scoring competitiveness, a questionnaire evaluating certain markets and competition characteristics of the company is presented to the analyst.
- Focus is on getting a picture of the company’s position in line with common SWOT and product life cycle analysis concepts.

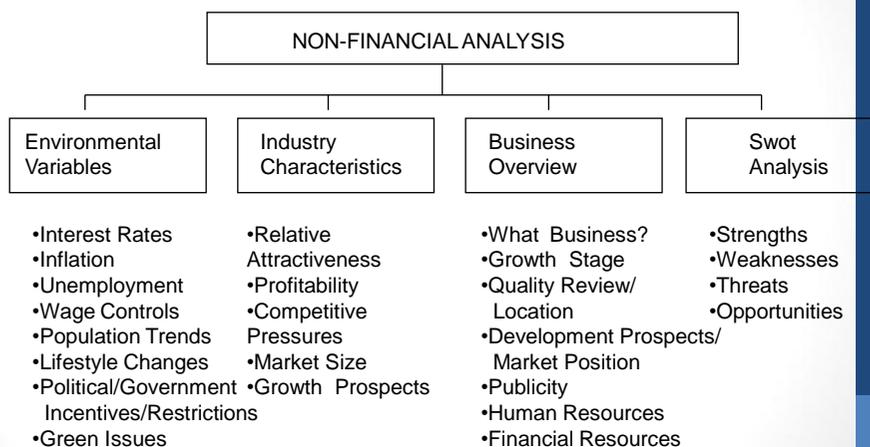
32

SME – Rating Sheet for “Management Quality”

- Analogous to the rating sheet for “market and competition”, management quality is scored. Focus is on total quality management, professionalism and management personality, transparency and control.

33

Business Analysis - checklist



34

Corporates - Ratings - based on Expert Judgement

Definition: The asset class corporates refers to large corporations. Middle market or small and medium-sized borrowers are not included.

The following data can be used for a rating tool for corporates:

- Spread of financial statement;
- Share Price
- Public announcements;
- (Confidential) information about management strategies;
- Industry reviews, peer comparison, and assessment of market position.

35

Ratings based on Expert Judgement

A typical rating system based on the sources mentioned, can be used to assess the creditworthiness of a corporate counterparty.

- Operating environment (medium to long-term industry outlook, special risks)
- Business and financial condition (quality of product offering, marketing strength, market standing/competition, dependencies, revenue development, ability to generate profits, long-term earnings outlook, internal cashflow generation after working capital, external cashflow generation, access to capital markets, debt to capitalisation ratio)

36

Ratings based on Expert Judgement

continued

- Management transparency (long-term management strategy, quality of operational management, management structure, continuity plans and succession, business planning).
- On many Large Corporates we can get the benefit of an External Rating Agency assessment of Grade - please see handout in Study Pack for detailed narrative about this and also some example ratings.

37

Basel II-Specialised Lending: an example-Project Finance

38

PROJECT FINANCE - DEFINITION

- **DEFINITION:**
A financing of a particular economic unit in which a lender is satisfied to look initially to the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan.
- Although the lender may be willing to look initially to the cash flows of a project for repayment as stated. The lender must feel comfortable that the loan will in fact be paid even on a worst case basis. This may involve undertakings or direct or indirect guarantees by third parties.

39

CREDIT ANALYSIS FROM THE VIEWPOINT OF A TERM LENDER

- Project companies are highly leveraged. Thus, anticipated cash flow is key, as the source of loan repayments. The following areas must be thoroughly analysed:
- Market and competition
- Stability of Expenses/Costs, including relations with suppliers, sources of raw materials etc.
- Projections of futures sales, earnings cash flow and balance sheets.
- Assumptions underlying the projections are as important as the numbers themselves and must be reviewed critically.
- Total cash needs of the enterprise must be reviewed in the projections, not only in terms of loan payments and capital expenditure, but working capital needs.

40

GENERAL CONSIDERATIONS FOR THE CREDIT DECISION

- Management - What are management's objectives and how will they be achieved. What are their financial and operating policies?
- Level and Stability of Earnings - Ability to generate good revenues consistently and to maintain adequate coverages and margins.
- Industry - Ranking, competition and trends within the industry. Past performance if applicable.

41

GENERAL CONSIDERATIONS FOR THE CREDIT DECISION

- Financial Resources - Current liquidity, cash flow relationships and current assets are important both from the standpoint of relative size and of quality.
- Asset Protection - Total long-term debt/net plant and net tangible assets/total long-term debt are calculated to determine the degree of protection afforded by the company's assets. e.g. real estate or natural resource companies.
- Guarantees and Securities - Further analysis is necessary, when specific guarantees exist or if debt is secured by a lien on tangible assets, to determine the value of these guarantees or liens.

42

Cash Flow Debt Service Key Ratios

Cashflow Interest Cover = $\frac{\text{Net Operating Cash Flow}}{\text{Interest Expense}^*}$

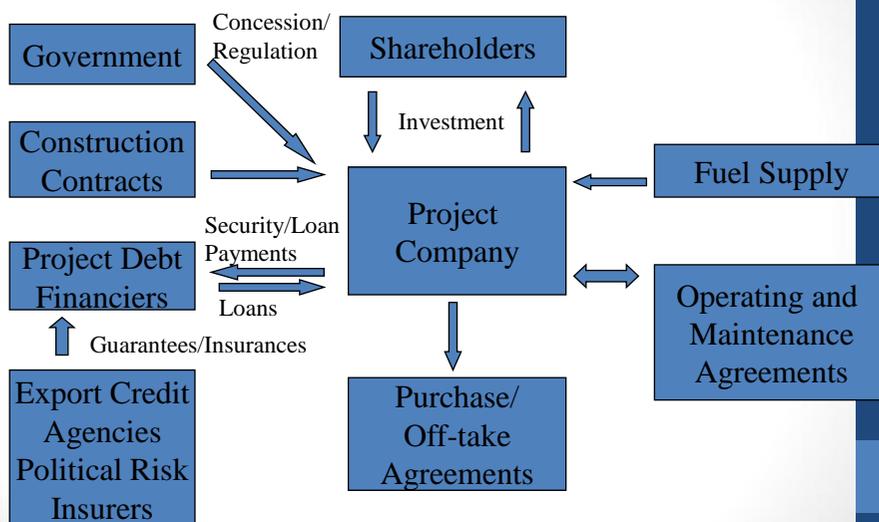
Debt Service Ratio = $\frac{\text{Net Operating Cash Flow}}{\text{ST, LT Debt payable in one year and interest expense}^*}$

Total Debt Payout = $\frac{\text{Total Interest Bearing Debt}}{\text{Net Operating Cashflow}}$

* Leasing payments should be added to interest expense as they represent an alternative form of interest expense.

43

Example Power Plant Project Finance Structure



44

Ratings based on Expert Judgement

A typical rating system based on the issues mentioned, can be used to assess the creditworthiness of a project finance transaction.

- A typical approach is described within the Basel II documentation
- see annex 6 - Supervisory Slotting Criteria for Specialised Lending Table 1 – Supervisory Rating Grades for Project Finance Exposures

- Reference www.bis.org

45

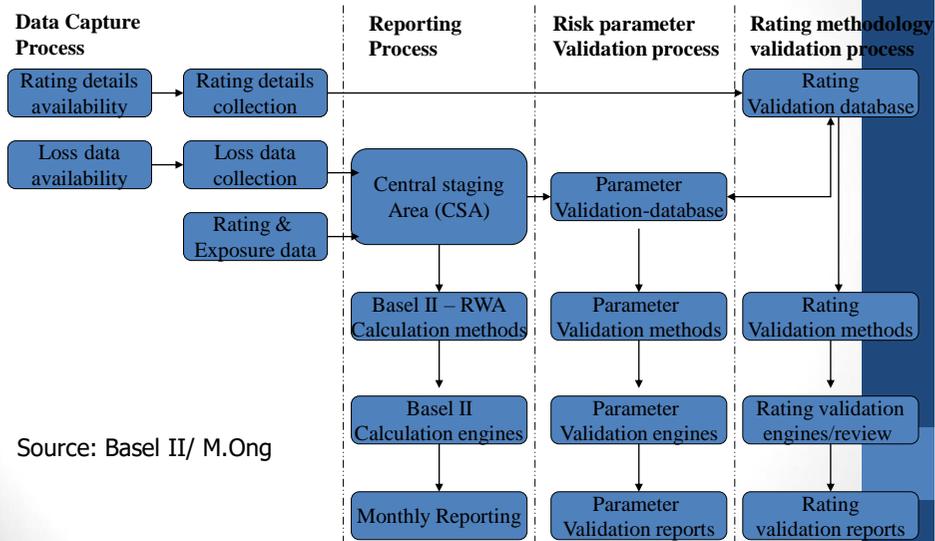
How to Structure a Basel II Credit Risk Implementation Project

Generally, the implementation project can be separated into the following processes:

- Data-collection process
- Reporting process
- Parameter-validation process
- Methodology-validation process

46

Components of the Basel II Implementation Project



47

Review

- Review - The main points introduced were :
- What is Credit Risk ?
- The Importance of Credit
- Prudent management of the Financial Institution is a reflection of its ability to balance successfully the risk in the portfolio with profit earned on it
- The primary vision when writing policy is to determine the institution's tolerance for accepting financial risks and articulate it when defining the risk parameters of the policy.
- Each financial institution is unique and this must be reflected in its policy.

48

Review **continued**

- RISK MANAGEMENT - BIS Standards-17 Key Principles
- Basel Extract: Principle 10: Banks are encouraged to develop and utilise an internal risk rating system in managing credit risk.
- The rating system should be consistent with the nature, size and complexity of a bank's activities.
- Credit Risk Rating Systems will assist with overall portfolio management by identifying and monitoring risk composition and formulate individual account management, which is proactive to problem causes and symptoms rather than reactive to default/collapse

49

Review **continued**

We continued by examining Credit Risk Rating Main Segments

- Micro Finance
 - Personal Lending
 - SME Businesses
 - Corporates
 - Project Finance
- And provided examples of how to construct templates for Rating purposes
 - and finally please see study pack for more written details and exercises

50

Credit

Risk Rating

Table of Contents

Credit Ratings	3
1 What is a credit rating?	3
2 The Two Basic Types of Credit Rating.....	3
2.1 Issue Specific Credit Rating	3
2.2 Issuer Rating.....	4
3 Ratings Hierarchies.....	4
4 Investment Grade versus Sub Investment Grade Ratings	6
5 Short Term versus Long Term Ratings	6
5.1 Long Term Ratings	6
5.2 Short Term Ratings.....	7
6 How are Credit Ratings Used and by whom?	8
7 The Process of Assigning and Monitoring a Rating	8
7.1 Assigning a Rating	8
7.2 Monitoring a Rating.....	8
8 How Accurate are the Credit Rating Agencies?	9
9 What Qualitative Factors are Considered in the Credit Rating Process?	9
10 What Quantitative factors are Evaluated in the Credit Rating Process?	10
11 Signs of distress.....	16
12 Appendix 1	19

Credit Ratings

1 What is a credit rating?

A credit rating is an independent and objective opinion of the likelihood of default of a company or country on either its debt obligations in general, or a particular debt security issue.

A credit rating measures the probability of default as well as the likely severity of loss if default occurs. It also measures both the ability and willingness of an issuer to make timely payments on debt obligations.

Investors use a rating to compare the credit risk of investing in a debt issuer or security with the credit risk of other rated debt issuers or securities.

The three main ratings agencies are Standard and Poor's, Moody's Investor Services and Fitch. Each of these agencies aims to provide an impartial rating system to help investors determine the risk associated with investing in a specific company, investing instrument or market.

The ratings provided by the agencies are not the same as **buy, sell or hold** recommendations and they are not intended to distinguish between a good company or a bad company. Additionally, although ratings tend to correspond fairly closely with the pricing on debt securities, there is not always a direct correlation since default risk is only one of many factors which influence pricing of debt securities. Ratings are intended only a measure of issuer creditworthiness and the likelihood and severity of loss if default occurs on debt obligations of an issuer.

An issuer of debt securities will typically receive financing on terms which correspond fairly closely with its credit rating; although again other factors such as supply and demand for a particular issuer's paper in the market may influence this. Ratings are issued following a request for a rating by an issuer of debt securities and a fee is payable for the rating agencies services.

Ratings can be assigned to governments, banks and other financial institutions, such as insurance companies as well as corporates. Ratings are assigned to short-term and long-term debt obligations and across a full range of debt instruments.

2 The Two Basic Types of Credit Rating

2.1 Issue Specific Credit Rating

An issue specific credit rating is a measure of the likelihood of default on a specific debt issue such as bonds, notes, commercial paper, preferred stock and municipal notes. This type of rating will take into consideration liquidation preferences on different debt obligations within an entity, the recovery prospects based on the seniority of the debt and will reflect any credit-enhancing techniques such as guarantees and contingent support arrangements.

Issue specific ratings are not intended to directly measure liquidity risk (a function of volume of trading), prepayment risk (the likelihood that the issuer will repay early), or the risk of interest rate and exchange movements, nor are they investment recommendations.

2.2 Issuer Rating

Issuer ratings may also be called the counterparty, corporate or sovereign credit rating. An issuer rating measures the issuer's creditworthiness based on the entity's financial capacity to meet all of its debt obligations. It indicates the likelihood of default regarding all of the issuer's financial commitments - it is not specific to a particular debt obligation and therefore does not take into account liquidation preferences.

An issuer can be rated long or short term. Both are intended to forecast the probability of default and the severity of loss given default.

Issuer ratings measure the credit risk of an entire organisation. The entity may be a government, or local government authority / municipality, corporation or financial institution

To attract debt capital to finance growth and expansion in an economy, it is an advantage for a country to have a sovereign rating. In most circumstances, a country's sovereign credit rating will be its upper limit of any local authority, corporate or financial institution credit ratings that may be issued for entities that are established and operating within that country.

3 Ratings Hierarchies

S&P and Fitch categorize their ratings from AAA to CCC, modified with a + or - to show their relative standing within a rating category. Moody's modifies its ratings categories with a 1 - high end, 2 - mid-range and 3 - lower end. These modifications are known as the notching within a rating category.

The following table sets out the rating hierarchy and describes the default expectations for each rating category.

Table 1

Description	Fitch & S&P		Moody's		Explanation
Highest credit quality	AAA		Aaa		Exceptionally strong capacity for timely payment of financial commitments which is highly unlikely to be adversely affected by foreseeable events
Very high credit quality	AA	AA+ AA AA-	Aa	Aa 1 Aa 2 Aa 3	Very strong capacity for timely payment of financial commitments which is not significantly vulnerable to foreseeable events
High credit quality	A	A+ A A-	A	A 1 A 2 A 3	Strong capacity for timely payment of financial commitments which may be more vulnerable to changes in circumstances / economic conditions
Good credit quality	BBB	BBB+ BBB BBB-	Baa	Baa 1 Baa 2 Baa 3	Adequate capacity for timely payment of financial commitments but adverse changes in circumstances / economic conditions are more likely to impair this capacity
Speculative	BB	BB+ BB BB-	Ba	Ba 1 Ba 2 Ba 3	Possibility of credit risk developing, particularly due to adverse economic change over time. Business / financial alternatives may be available to allow financial commitments to be met
Highly speculative	B	B+ B B-	B	B 1 B 2 B 3	Significant credit risk with a limited margin of safety. Financial commitments currently being met; however, continued payment is contingent upon a sustained, favourable business and economic environment.
High default risk	CCC		Caa		Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favourable business or economic developments
Probable default	CC		Ca		Default of some kind appears probable
Likely default	C		C		Default imminent

4 Investment Grade versus Sub Investment Grade Ratings

Ratings above and including Baa3 by Moody's and BBB- are known as investment grade ratings. A rating below this level is known as sub-investment grade. Sub-investment grade debt securities carry higher expected returns for investors than sub-investment grade securities to compensate investors for the higher risks involved. Sub investment grade bonds are therefore known as high yield bonds, or more pejoratively as "junk bonds". The demand from investors for investment grade securities is much higher than sub-investment grade securities and investment grade securities are more actively traded. This leads to greater liquidity and the lower liquidity risk is another reason why investment grade securities provide lower yields to investors in comparison with sub-investment grade bonds.

5 Short Term versus Long Term Ratings

5.1 Long Term Ratings

The objective of an agency in producing a long term rating is to rate 'through the cycle'. This means that where an issuer operates in a cyclical business, such as the heavy industrials sector where revenues are driven by the economic cycle in general and GDP in particular then, under these circumstances, the rating agency may not adjust the rating where performance is affected due to cyclical downturns or upturns within a normal tolerance range. This is one reason why long term ratings may not directly correlate with short term pricing movements in debt securities.

Table 2

LONG-TERM RATING	CHARACTERISTICS
AAA/Aaa	Highest quality due to the extremely strong capacity to pay interest and repay principal. Risk factors are negligible.
AA/Aa	Very strong capacity to pay interest and repay principal. Rated lower than the highest quality bonds because margins of protection are not as large.
A/A	Strong capacity to make interest and principal payments, although somewhat more susceptible to adverse effects of changes in circumstances and economic conditions.
BBB/Baa	Adequate capacity to pay interest and repay principal. Protection factors are deemed sufficient for prudent investment, but adverse economic conditions or changing circumstances are more likely to lead to weakened capacity to pay.
BB/Ba	Bonds that are judged to have speculative elements. Their future cannot be considered as well assured.

5.2 Short Term Ratings

Moody's Investor Services denotes short term prime ratings as either P1, P2, or P3. Short term debt securities issued by issuers who do not achieve this grading are known as non prime. Standard and Poor's denote their short term ratings as either A1, A2 or A3.

A prime (A1, A2, A3) rating is an all in opinion of an issuer's short term credit risk including the issuer's fundamental credit quality, vulnerability to shock risk, reliance on short term funding, adequacy of on-balance sheet liquidity and adequacy of alternate liquidity.

Achieving a short term rating at A1/P1 or A2/P2 is key for corporates seeking to access the commercial paper markets at attractive rates. The commercial paper market is not available to corporate that have not achieved a prime rating.

Table 3

SHORT-TERM RATING	CHARACTERISTICS
A-1/P-1	Superior ability for timely repayment of senior short-term debt obligations. S&P give a '+' designation to issues that possess extremely strong safety characteristics.
A-2/P-2	Capacity for timely payment is satisfactory. However the relative degree of safety is not as high for the issues as for issues designated A-1/P-1.
A-3/P-3	Acceptable ability for timely repayment. More vulnerable to the adverse effects of changes in circumstances.

Liquidity risk assessment is an important part of determining the short term credit rating for an issuer. As mentioned, liquidity risk is primarily a function of volume of trading and this risk is not directly measured by the ratings agencies. The focus of the rating agencies is therefore not the likelihood that an issuer will lose market access, but instead how well the issuer could deal with it if they did.

For a corporate issuer, liquidity risk assessment by the ratings agencies will take into consideration three aspects. Firstly, how much cash and available liquid resources such as marketable securities is available on the balance sheet? Secondly, for how long will the company be able to maintain regular business activity including the capital expenditure required to maintain regular business, given its liquidity resources? Thirdly, how likely is it that the company would be able to draw on its available facilities if they were required?

6 How are Credit Ratings Used and by whom?

Appropriately used, ratings are a key means of promoting efficiency in the debt securities markets. Inappropriately used, they lose meaning and encourage issuers to 'shop' for the highest rating in order to meet a minimum quality standard. This encourages lower quality ratings in a market.

Investors use credit ratings to help them control and manage the probability of future defaults.

Issuers use ratings to get wider or more stable access to the debt capital markets, to reduce borrowing costs and for more efficient new issuance.

Banks use ratings to assist them in making credit decisions and in the planning, pricing and placement of securities on behalf of their clients.

Regulators use ratings to help them monitor the financial soundness of the organizations for which they are responsible ranging from banks to insurance companies to public utilities.

7 The Process of Assigning and Monitoring a Rating

7.1 Assigning a Rating

Assigning a corporate rating involves gathering relevant qualitative and quantitative information (see below) about the issuer and the issuer's environment and additionally for an issue specific rating details about the issue structure.

The information is then analyzed to identify the critical factors that affect the creditworthiness of the issuer and the issuer's ability to weather these critical risk factors.

The rating recommendation is then put forward and a rating decision is reached via a process of rating committee discussion and approval.

Once the rating has been decided on, the issuer is informed of the rating and of the rationale in arriving at the rating. New ratings are typically distributed by press release to the major financial media worldwide prior to any major planned debt security issues so that investors may use these opinions in their purchase decisions.

7.2 Monitoring a Rating

Ratings are continuously monitored and updated when required. Economic, industry and regulatory trends as appropriate are gathered and monitored. The performance of the issuer is also tracked in order to identify and make changes in a timely manner. Although the rating agencies are sometimes criticized for slowness in adjusting a rating and also for failure to spot problems such as accounting irregularities, ultimately the rating agencies reputation depends upon the accuracy and dependability of their ratings.

8 How Accurate are the Credit Rating Agencies?

In practice, there is a high degree of correlation between credit ratings and the actual experience of corporate defaults. This is set out in the table below.

Table 4

Good grades				
Cumulative average corporate default rates*				
1981-2004, %				
Rating	1 year	5 years	10 years	15 years
AAA	0.00	0.10	0.45	0.61
AA	0.01	0.30	0.85	1.35
A	0.04	0.61	1.94	2.98
BBB	0.29	2.99	6.10	8.72
BB	1.20	11.25	19.20	22.59
B	5.71	25.40	33.75	38.63
CCC/C	28.83	50.85	56.45	59.44
Investment grade	0.11	1.20	2.71	3.92
Speculative grade	4.91	20.22	28.25	32.42
All rated	1.64	7.08	10.45	12.51

Source: Standard & Poor's *By years after initial rating

9 What Qualitative Factors are Considered in the Credit Rating Process?

For a corporate credit rating, the rating will take into consideration the issuer's macro and economic environment, regulatory issues, industry risk, market position, operating and financial position, accounting quality, management and company structure.

A sovereign credit rating signifies a country's overall ability to provide a secure investment environment. This rating reflects factors such as a country's economic status, levels of public and private investment flows and foreign direct investment, foreign currency reserves and political stability.

10 What Quantitative factors are Evaluated in the Credit Rating Process?

For a corporate credit rating, the rating will take into consideration financial characteristics and policy, profitability, capital structure, cash flow protection and financial flexibility. Ratio analysis is used to help judge the company's financial strength and ability to repay it's debt and the gauge the company's relative strength within its industry.

The tables below are examples of some specific key ratios used firstly by Moody's* and secondly by Standard and Poor's*.

*ref: <http://www.moodys.com/>

* ref: <http://www2.standardandpoors.com/>

1 Extract for Moody's: Global Auto Supplier Industry
Effective Date: 29 June 2005

Industry Rated Issuers and Key Ratios 2003/2004

Credit Metrics Statistics (Ratings and Outlooks as of 30 April 2005)

Rating	Outlook	Name	FYE	Sales (in USD)	1-year Adj. EBIT Margin	5-year Adj. EBIT Margin	Cash & Cash equivalents / Total Assets	Adj. Net Debt / Adj. Net Capitali- sation	Total Coverage Ratio	Adj. RCF (post WC) / Adj. Net Debt	FCF / Adj. Gross Debt	Adj. Gross Debt / EBITDAR	Return on Average Assets	Number of issuers
Aaa	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Aa1	Stable	Denso	2003	24,438	7.4%	6.4%	32.2%	-32.7%	43.3	-48.5%	4.9%	-1.1	8%	
Aa		MEAN		24,438	7.4%	6.4%	32.2%	-32.7%	43.3	-48.5%	4.9%	-1.1	8%	1
Aa		MEDIAN		24,438	7.4%	6.4%	32.2%	-32.7%	43.3	-48.5%	4.9%	-1.1	8%	
A2	Stable	Johnson Controls	2004	26,553	4.7%	5.4%	1.0%	46.4%	6.0	29.1%	1.6%	2.5	8%	
A3	Stable	Bridgestone	2004	23,048	8.2%	7.6%	19.2%	32.8%	10.0	39.6%	-15.7%	1.4	8%	
A3	Negative	Valeo	2004	12,148	3.3%	3.8%	11.8%	47.3%	3.9	34.5%	2.1%	2.9	4%	
A		MEAN		20,583	5.4%	5.6%	10.7%	42.2%	6.6	34.4%	-4.0%	2.3	7%	3
A		MEDIAN		23,048	4.7%	5.4%	11.8%	46.4%	6.0	34.5%	1.6%	2.5	8%	
Baa1	Stable	Compagnie Financiere Michelin	2004	20,192	8.3%	7.5%	9.8%	53.0%	4.1	22.8%	0.3%	3.1	8%	
Baa1	Stable	Continental	2004	16,213	8.6%	6.3%	10.9%	44.3%	7.2	45.7%	10.3%	2.1	11%	
Baa1	Stable	Koyo Seiko	2003	4,818	4.3%	2.4%	16.0%	55.4%	6.6	26.4%	10.6%	3.4	4%	
Baa1	Stable	NSK	2003	4,980	5.0%	3.4%	22.2%	38.7%	4.0	19.4%	2.8%	2.5	4%	
Baa1	Stable	NTN	2003	3,408	6.9%	4.5%	10.3%	55.4%	8.5	21.7%	1.1%	3.7	5%	
Baa2	Positive	BorgWarner	2004	3,525	9.3%	9.3%	6.3%	29.9%	9.5	69.2%	22.4%	1.8	10%	
Baa2	Positive	Knorr-Bremse AG	2004	3,119	9.6%	7.4%	2.3%	64.2%	10.9	33.7%	21.8%	2.0	16%	
Baa2	Positive	Kolbenschmidt-Pierburg AG	2004	2,532	6.6%	4.4%	5.2%	51.0%	6.5	48.3%	20.5%	1.8	10%	
Baa2	Stable	Hella KGaA Hueck & Co.	2004	4,126	3.2%	4.3%	6.3%	60.4%	2.5	8.5%	-17.7%	3.0	5%	
Baa3	Positive	Harman International	2004	2,711	9.0%	6.8%	15.0%	39.7%	6.6	90.7%	33.4%	2.3	10%	
Baa3	Stable	GKN Holdings Plc	2004	8,483	2.5%	5.8%	21.5%	39.1%	2.1	18.4%	56.2%	6.0	3%	
Baa3	Stable	Cooper Tire ¹	2004	2,082	2.9%	4.3%	32.9%	7.9%	1.0	135.4%	-11.1%	5.4	2%	
Baa3	Negative	American Axle	2004	3,600	8.5%	8.8%	0.5%	43.2%	7.6	56.0%	4.2%	1.6	11%	
Baa3	Negative	Lear Corporation	2004	16,960	4.3%	4.9%	5.3%	53.4%	3.9	21.6%	0.9%	3.2	7%	
Baa		MEAN		6,911	6.4%	5.7%	11.7%	45.4%	5.8	44.1%	11.1%	3.0	8%	14
Baa		MEDIAN		3,863	6.8%	5.3%	10.1%	47.7%	6.6	30.0%	7.2%	2.7	7%	
Ba1	Stable	ArvinMeritor	2004	8,033	3.9%	5.2%	2.2%	66.9%	2.7	20.3%	15.0%	4.3	5%	
Ba2	Stable	Dana Corporation	2004	9,056	2.4%	2.7%	6.4%	49.8%	1.0	9.8%	21.8%	5.5	2%	
Ba2	Stable	Sun Sage ^{** 1}	2003	1,250	12.4%	12.1%	3.1%	60.2%	6.6	31.6%	7.9%	1.8	15%	
Ba2	Stable	TRW Automotive	2004	12,011	5.1%	5.6%	7.5%	74.3%	2.3	20.5%	2.1%	4.3	6%	
Ba2	RUR – DG	Delphi Corporation	2003	28,096	2.4%	3.9%	3.9%	83.7%	3.1	26.7%	11.1%	4.6	3%	
Ba3	Stable	Shiloh Industries, Inc.	2004	639	6.3%	2.0%	0.7%	61.8%	3.7	37.7%	29.4%	3.0	9%	
Ba3	Stable	Stoneridge	2004	682	8.5%	9.4%	9.9%	57.3%	2.2	25.1%	10.8%	3.0	10%	
Ba		MEAN		8,538	5.9%	5.8%	4.8%	64.9%	3.1	24.2%	14.0%	3.8	7%	7
Ba		MEDIAN		8,033	5.1%	5.2%	3.9%	61.8%	2.7	25.1%	11.1%	4.3	6%	

Moody's Credit Metrics Statistics (Ratings and Outlooks as of 30 April 2005)

Rating	Outlook	Name	FYE	Sales (in USD)	1-year Adj. EBIT Margin	5-year Adj. EBIT Margin	Cash & Cash equivalents / Total Assets	Adj. Net Debt / Adj. Net Capitali- sation	Total Coverage Ratio	Adj. RCF (post WC) / Adj. Net Debt	FCF / Adj. Gross Debt	Adj. Gross Debt / EBITDAR	Return on Average Assets	Number of issuers
B1	Positive	Tenneco Automotive	2003	3,766	4.9%	6.2%	4.7%	92.0%	1.2	15.1%	7.6%	5.8	6%	
B1	Stable	Cooper-Standard Automotive	2004	1,859	8.2%	6.3%	1.0%	70.8%	2.1	18.7%	12.8%	4.4	9%	
B1	Stable	Durr AG	2003	2,915	2.0%	3.0%	9.0%	56.1%	1.6	17.5%	2.5%	5.8	2%	
B1	Stable	HLI Operating Company Inc. (Hayes Lemmerz)	2004	2,056	3.5%	4.5%	2.0%	60.1%	1.1	12.1%	-2.1%	4.9	3%	
B1	Stable	Mark IV Industries Inc.	2004	1,450	6.6%	7.6%	7.0%	92.0%	1.8	7.9%	4.0%	11.4	4%	
B1	Stable	Standard Motor Products	2003	679	2.4%	4.0%	2.5%	58.0%	1.1	10.2%	-21.4%	7.8	2%	
B1	Stable	United Components, Inc.	2004	1,027	9.2%	9.3%	1.1%	65.3%	2.5	14.7%	4.9%	4.2	9%	
B1	Negative	Goodyear Tire	2004	18,370	4.2%	2.0%	10.5%	87.2%	1.9	13.6%	4.4%	6.6	4%	
B1	Negative	Hilite Industries, Inc.	2004	384	5.3%	10.0%	0.4%	46.3%	1.5	12.7%	3.1%	4.2	4%	
B1	Negative	J.B. Poindexter & Co.	2003	436	5.7%	4.6%	0.4%	102.7%	1.9	10.2%	-2.1%	4.4	12%	
B1	Negative	Plastech Engineered Products *	2004	1,040	7.9%	7.7%	0.1%	89.3%	1.9	9.3%	2.0%	5.4	8%	
B1	Negative	TI Automotive	2003	2,998	7.5%	7.9%	3.5%	65.2%	2.6	27.7%	15.5%	4.0	8%	
B1	RUR – DG	Visteon Corporation	2004	18,657	-0.1%	0.7%	6.8%	81.7%	0.1	17.1%	-9.4%	6.0	0%	
B2	Positive	Accuride Corporation	2004	494	15.6%	10.8%	11.8%	111.1%	2.2	14.6%	7.1%	4.8	13%	
B2	Stable	Advanced Accessory Systems	2003	358	8.0%	9.2%	4.1%	69.2%	1.5	7.1%	-39.2%	5.6	8%	
B2	Stable	Remy International	2003	973	8.7%	8.5%	2.5%	144.2%	1.5	4.6%	2.2%	6.8	9%	
B2	Stable	Dura Automotive	2003	2,381	5.7%	7.4%	1.4%	82.2%	1.5	10.2%	0.7%	6.5	6%	
B2	Stable	Exide Technologies, Inc. *	2004	2,654	1.1%	2.5%	0.8%	69.6%	0.6	3.4%	-2.4%	7.2	1%	
B2	Stable	Meridian Automotive System ***	2003	1,025	3.5%	4.2%	0.5%	134.0%	1.3	10.8%	4.2%	7.3	5%	
B2	Stable	Metokote	2004	201	12.9%	13.3%	5.7%	123.3%	2.5	23.4%	8.7%	4.3	14%	
B2	Stable	Stanadyne Holdings, Inc.	2004	336	10.4%	6.9%	0.3%	76.6%	1.7	2.6%	-68.3%	6.1	8%	
B2	RUR – DG	Metaldyne	2003	1,508	2.5%	7.5%	0.6%	63.7%	0.6	10.3%	-1.8%	8.8	2%	
B2	Negative	Schefenacker AG ¹	2003	1,259	4.6%	4.6%	2.9%	76.4%	1.5	22.6%	9.6%	3.5	5%	
B2	Negative	TK Aluminium (Teksid)	2003	1,149	4.1%	2.5%	8.0%	63.4%	0.6	16.4%	2.8%	5.6	4%	
B3	Stable	J.L. French Automotive Castings	2003	521	9.6%	10.9%	0.5%	203.9%	0.8	5.1%	-0.7%	6.8	10%	
B3	Negative	Special Devices	2004	105	5.7%	4.9%	6.9%	130.7%	0.7	9.6%	3.0%	5.9	6%	
B3	Negative	Collins & Aikman Products	2003	3,984	4.3%	5.3%	0.4%	77.2%	1.1	3.0%	-7.0%	6.7	5%	
B3	RUR – DG	Autocam Corporation ²	2004	350	8.8%	8.2%	0.3%	65.3%	1.7	4.8%	-2.5%	6.1	5%	
B		MEAN		2,605	6.17%	6.45%	3.42%	87.77%	1.5	12.0%	-2.2%	5.9	6%	28
B		MEDIAN		1,094	5.71%	6.60%	2.24%	76.91%	1.5	10.6%	2.3%	5.8	6%	
Caa2	Stable	Holley Performance Products Inc.	2004	130	13.3%	4.5%	0.0%	236.0%	0.8	1.1%	-0.7%	8.8	15%	
Caa		MEAN		130	13.3%	4.5%	0.0%	236.0%	0.8	1.1%	-0.7%	8.8	15%	1
Caa		MEDIAN		130	13.3%	4.5%	0.0%	236.0%	0.8	1.1%	-0.7%	8.8	15%	
Ca	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
C	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Total														54

Moody's Key Ratio Definitions:

ADJUSTED EBIT MARGIN

Operating Profit = Net revenue – operating expenses +/- one-time non recurring charges / (gains) + Adjustment of net capitalised R&D expenses

Adjusted EBIT = Operating profit before goodwill amortisation

Adjusted EBIT margin = EBIT / net revenue

RETURN ON AVERAGE ASSETS

Average Assets (n) = (Total assets (n) + 8*rents (n) + Total assets (n-1) + 8*rents (n-1)) / 2
Return on Average Assets = Adjusted EBIT / average assets

ADJUSTED RCF / NET ADJUSTED DEBT

Cash flow from Operations (CFO) = cash flow from operating activities from the Consolidated Statement of Cash Flow

Adjusted Retained Cash Flow (RCF) = CFO before changes in working capital +/- Change in Working Capital - Preferred Dividends – Common Dividends + 2/3 rent expenses + pension contribution above service costs - net capitalised R&D expenses (in case not included in CFO)

Adjusted gross Debt = gross debt + 8*rents + under funded pension liabilities + "basket adjusted" hybrids + cash earn-outs + accounts receivable securitisation outstanding + guarantees of debt obligations + share trusts + off-balance sheet debt-like obligations + other debt like items

Net Adjusted Debt = adjusted gross Debt – cash & marketable securities (with no haircut on cash)

FCF / ADJUSTED GROSS DEBT

FCF = CFO before changes in working capital +/- Change in Working Capital - Preferred Dividends – Common Dividends – CAPEX (Investments in Property, Plant, Equipment and intangibles excluding capitalised R&D expenses) + pension contribution above service costs – net capitalised R&D expenses (in case not included in CFO) – Acquisitions + Dispositions – Share Buybacks

ADJUSTED GROSS DEBT / EBITDAR

EBITDA = adjusted EBIT + depreciation + amortised portion of capitalised R&D expenses

EBITDAR = EBITDA + rent expenses

TOTAL COVERAGE RATIO

Total Coverage = (EBIT + 1/3 rent) / (cash interest expense + 1/3 rent + (preferred dividends) / (1 - Tax Rate))

NET ADJUSTED DEBT / ADJUSTED NET CAPITALISATION

Net adjusted Debt / Adjusted net capitalisation

Adjusted net capitalisation = Net adjusted debt + shareholders equity (common and preferred) + minority interests + deferred taxes

Moody's Example of Rating Grid:

Continental AG

Public Rating: Baa1 (at 04/30/2005)

Model Rating: Baa1

Continental AG Comments

1 - Scale, diversification and competitive position		
a) Scale and market position	A	Between \$13 billion and \$19 billion total sales
b) Competitive position / barriers to entry	A/Baa	High level of technological content in product portfolio stabilizes revenue base
c) Geographic diversification	Baa/Ba	Concentration on European Region
d) Segmental / product diversification	A/Baa	Balanced business unit portfolio
e) Customer diversification / concentration	Baa	Limited customer concentration. Solid aftermarket proportion of sales.
2 - Revenue growth		
a) 4-year Revenue growth (CAGR)	Aaa-Aa	> 5%
b) R&D expenditure as a % of sales	Baa	R&D spendings between 4-6% of annual sales
3 - Cost position and profitability		
a) Profitability (Adjusted EBIT Margin)	A/Baa	1-year adjusted EBIT Margin above 7%, 5-year adjusted EBIT Margin between 5-7%
b) Operating efficiency - Labor efficiency	A/Baa	Revenue per employee around \$220k
c) Operating efficiency - Asset Turnover	A	Asset Turnover Rate between 1.2-1.3x
4 - Cash flow variability		
a) Ability to generate Free Cash Flow through the business cycle	Baa	Positive Free Cash Flow generation in the majority of last years
b) Reinvestment strategy (CAPEX/Depreciation)	Baa	Capex amount comparable to depreciation
5 - Financial policy and capital structure		
a) Financial strategy	A	Predictable financial policy, balanced between shareholders and creditors
b) Capital structure: Adj. Net Debt / Adj. Net Capitalisation	Ba	Ratio over 40%
c) Debt Maturities / Debt Structure	Baa	Balanced debt maturity profile and solid variety of debt instruments
d) Cash Reserves and Credit Line availability	Baa	Consistently strong liquidity management and contingency planning
e) M&A risk	Ba	Significant
6 - Key Credit Metrics		
a) Total Coverage Ratio	Aaa-Aa	Ratio above 7x
b) Adj. RCF (post WC) / Adj. Net debt	A	Ratio above 30%
c) FCF / Adj. Gross Debt	Baa	Ratio above 8%
d) Adj. Gross Debt / EBITDAR	Baa	Ratio above 2x
e) Return on average assets	A	Ratio at 11%
WEIGHTED RATING AVERAGE	Baa1	

*2 Extract for Standard & Poor's: Corporate Criteria Book
Effective Date: 24 July 2006*

Table 1—Key Industrial Financial Ratios, Long-Term Debt**Three-year (2002 to 2004) medians**

	AAA	AA	A	BBB	BB	B	CCC
EBIT interest coverage (x)	23.8	19.5	8.0	4.7	2.5	1.2	0.4
EBITDA interest coverage (x)	25.5	24.6	10.2	6.5	3.5	1.9	0.9
FFO/total debt (%)	203.3	79.9	48.0	35.9	22.4	11.5	5.0
Free operating cash flow/total debt (%)	127.6	44.5	25.0	17.3	8.3	2.8	(2.1)
Total debt/EBITDA (x)	0.4	0.9	1.6	2.2	3.5	5.3	7.9
Return on capital (%)	27.6	27.0	17.5	13.4	11.3	8.7	3.2
Total debt/total debt + equity (%)	12.4	28.3	37.5	42.5	53.7	75.9	113.5

Table 2—Key Utility Financial Ratios, Long-Term Debt**Three-year (2002 to 2004) medians**

	AA	A	BBB	BB	B
EBIT interest coverage (x)	4.4	3.1	2.5	1.5	1.3
FFO interest coverage (x)	5.4	4.0	3.8	2.6	1.6
Net cash flow/capital expenditures (%)	86.9	76.2	100.2	80.3	32.5
FFO/average total debt (%)	30.6	18.2	18.1	11.5	21.6
Total debt/Total debt + equity (%)	47.4	53.8	58.1	70.6	47.2
Common dividend payout (%)	78.2	72.3	64.2	68.7	(4.8)
Return on common equity (%)	11.3	10.8	9.8	4.4	6.0

Table 3—Key Ratios**Formulas**

1. EBIT interest coverage	Earnings from continuing operations* before interest and taxes/Gross interest incurred before subtracting capitalized interest and interest income
2. EBITDA interest coverage	Adjusted earnings from continuing operations** before interest, taxes, depreciation, and amortization/Gross interest incurred before subtracting capitalized interest and interest income
3. Funds from operations (FFO)/total debt	Net income from continuing operations, depreciation and amortization, deferred income taxes, and other non-cash items/Long-term debt [§] + current maturities + commercial paper, and other short-term borrowings
4. Free operating cash flow/total debt	FFO – capital expenditures – (+) increase (decrease) in working capital (excluding changes in cash, marketable securities, and short-term debt)/Long-term debt [§] + current maturities, commercial paper, and other short-term borrowings
5. Total debt/Total debt + equity	Long-term debt [§] + current maturities, commercial paper, and other short-term borrowings/Long-term debt [§] + current maturities, commercial paper, and other short-term borrowings + shareholders' equity (including preferred stock) + minority interest
6. Return on capital	EBIT/Average of beginning of year and end of year capital, including short-term debt, current maturities, long-term debt [§] , non-current deferred taxes, minority interest, and equity (common and preferred stock)
7. Total debt/EBITDA	Long-term debt [§] + current maturities, commercial paper, and other short-term borrowings/Adjusted earnings from continuing operations before interest, taxes, and D&A

*Including interest income and equity earnings; excluding nonrecurring items. **Excludes interest income, equity earnings, and nonrecurring items; also excludes rental expense that exceeds the interest component of capitalized operating leases. §Including amounts for operating lease debt equivalent, and debt associated with accounts receivable sales/securitization programs.

11 Signs of distress

Companies start to exhibit signs of distress and decline and these are typified by worsening ratios. Profitability ratios decline and turnover ratios such as asset turnover show lower activity. Borrowings tend to increase to fund the slowdown in the operating cycle.

- Core ratios – lower return on equity by a decline in the components of return on sales, asset leverage and asset turnover
- Profitability – declining sales, profitability and possibly increasing overheads relative to sales
- Liquidity – reduced working capital, declining creditor days and increasing stock and debtor days. This may also be combined with lower turnover and activity giving rise to stagnation.
- Financial structure – weakened structure with more reliance on debt
- Cash flow – reduced cash flow to meet commitments and negative trading cash flow

The company used in the example shows few signs of bankruptcy with the balance sheet increasing in strength over period.

Beaver and Altman Z scores

These methods pick out key ratios as indicators of a company's financial health and attempt to show a link to companies that subsequently fail.

Beaver studied a variety of long term and current ratios and found the best single predictor to be these ratios:

- Cash Flow / Total Debt
- Net Income / Total Debt
- Total Debt / Total Assets

Client: Tesco plc

Ref	Item	GBP'000,000	Reference	Feb-05	Feb-06	Feb-07	Feb-08	Feb-09	Feb-10
				Actual	Forecast	Forecast	Forecast	Forecast	Forecast
Beaver Model									
Z010	Cash flow / total debt		LC29/B27+B32	0.11	0.14	0.21	0.22	0.24	0.25
Z011	Net income / total debt		P23/B27+B32	0.27	0.32	0.33	0.34	0.36	0.37
Z012	Total debt / total assets		B27+B32/B23	0.25	0.25	0.25	0.25	0.25	0.24
Bathory's Model									
Z015	X1 - Gross cash flow / current debt	0.20	P23+P12.13/B27+B32	0.420	0.442	0.444	0.452	0.461	0.470
Z016	X2 - Pretax profit / capital employed	0.20	P15/B32+B38	0.144	0.147	0.148	0.148	0.149	0.149
Z017	X3 - Equity / current liabilities	0.20	B38/B31	1.483	1.675	1.696	1.724	1.756	1.794
Z018	X4 - Tangible net worth / total liabilities	0.20	B38-B20/B40	0.390	0.397	0.402	0.408	0.414	0.422
Z019	X5 - Working capital / total assets	0.20	R36/B23	(0.128)	(0.062)	(0.018)	0.028	0.075	0.121
Formula = 0.2 * X1 + 0.2 * X2 + 0.2 * X3 + 0.3 * X4 + 0.2 * X5				0.462	0.520	0.534	0.552	0.571	0.591
Z-Score									
Z024	Working capital / total assets			(0.128)	(0.062)	(0.018)	0.028	0.075	0.121
Z025	Retained earnings / total assets			0.422	0.430	0.435	0.440	0.446	0.453
Z026	EBIT / total assets			0.095	0.102	0.103	0.104	0.105	0.105
Z027	Market value equity / total liabilities			4.987	4.455	4.050	3.682	3.347	3.043
Z028	Sales / total assets			1.665	1.668	1.659	1.648	1.634	1.618
Z Score: If Publicly Held									
Z031	1.2 * Working capital / total assets	2.9	1.200	(0.154)	(0.075)	(0.022)	0.034	0.090	0.146
Z032	1.4 * Retained earnings / total assets	1.81	1.400	0.591	0.602	0.609	0.616	0.625	0.634
Z033	3.3 * EBIT / total assets		3.300	0.315	0.337	0.341	0.344	0.346	0.348
Z034	0.6 * Market value equity / total liabilities		0.600	2.992	2.673	2.430	2.209	2.008	1.826
Z035	0.999 * Sales / total assets		0.999	1.663	1.667	1.658	1.646	1.632	1.616
Z036	Public Z Score Sum		Slope (129.307)	5.407	5.204	5.015	4.849	4.701	4.570

CV_19 Failure ratios

Another approach to failure prediction is to combine a number of ratios and calculate a score. Edward Altman in his paper published in 1968 ('Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy', *Journal of Finance*, September 1968, 589-609) used multi discriminant analysis to create a scoring system based on five key ratios. The ratios are then multiplied by a weighting factor to derive a score.

- Altman's Z-score: $Z = 1.2 \times Y1 + 1.4 \times Y2 + 3.3 \times Y3 + 0.6 \times Y4 + 1.0 \times Y5$

Where:

- Y1 = Working capital / Total assets
- Y2 = Retained earnings to date / Total assets
- Y3 = Profit from ordinary activities before interest and tax / Total assets
- Y4 = Market value / Book value of total debt
- Y5 = Sales / Total assets

The ratios used and the weightings given to them were estimated empirically from extensive analysis of companies which had collapsed. It was found that such companies had common characteristics in terms of selected financial ratios. The scores are:

- >2.99 Unlikely to fail
- 1.8 > 2.99 Unsure
- <1.8 Likely to fail

In the example above, the company shows increasing scores using both the Beaver and Altman approaches and this is confirmed by the other ratios calculated so far.

Z-score models are used routinely by most of the large banks and accountancy firms, however you should consider that they are based on the accounting model with all the weaknesses of other ratios, for example international comparisons. They may be used to:

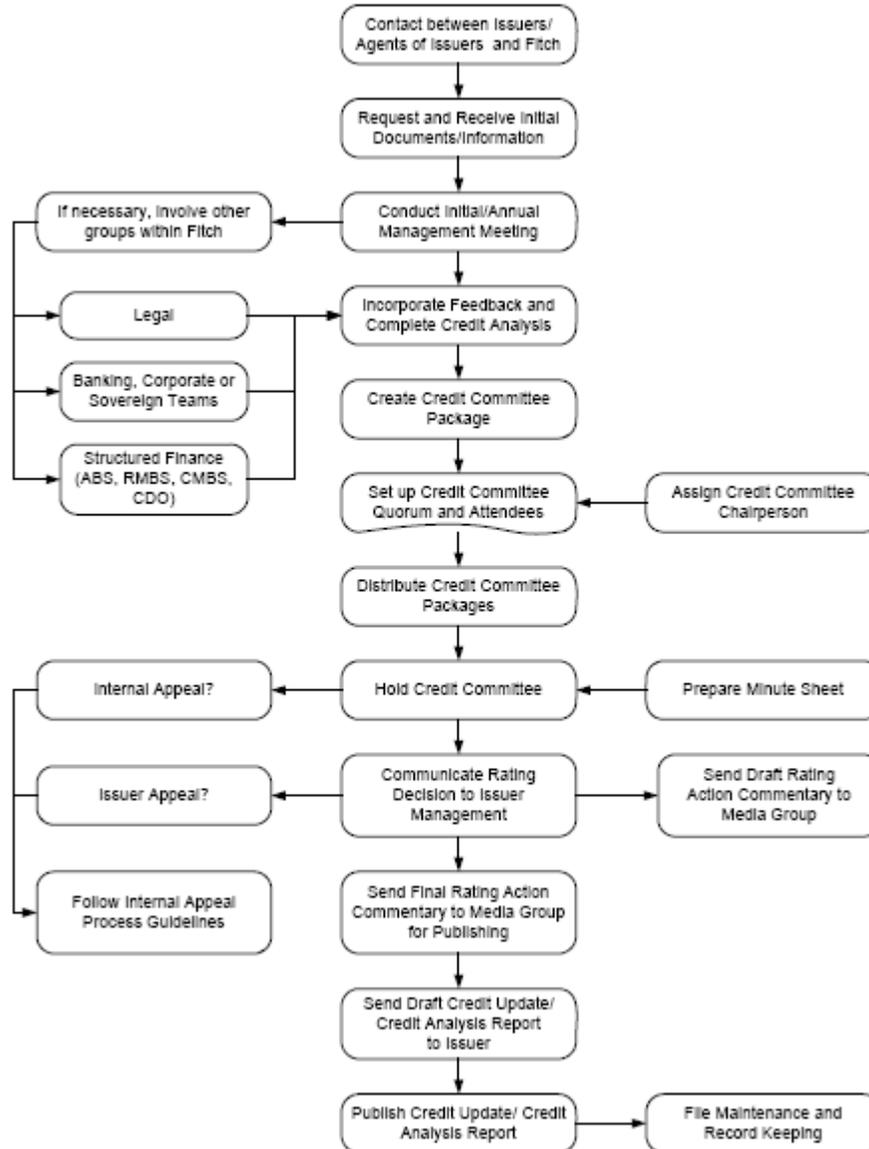
- Track a company's progress over time
- Compare companies of similar sizes in the same sector of industry

Nevertheless, this type of analysis adds more information to the traditional ratio analysis and should add weight to the same conclusion.

12 Appendix 1

Extract for Fitch: The Rating Process*
Effective Date: 27 July 2006

Credit Rating Process Flow Chart²



² Provided for illustrative purposes; timing and order of certain steps may vary

* Ref: www.fitchratings.com

Annex 6

Supervisory Slotting Criteria for Specialised Lending

Table 1 – Supervisory Rating Grades for Project Finance Exposures

	Strong	Good	Satisfactory	Weak
Financial strength				
Market conditions	Few competing suppliers or substantial and durable advantage in location, cost, or technology. Demand is strong and growing	Few competing suppliers or better than average location, cost, or technology but this situation may not last. Demand is strong and stable	Project has no advantage in location, cost, or technology. Demand is adequate and stable	Project has worse than average location, cost, or technology. Demand is weak and declining
Financial ratios (e.g. <i>debt service coverage ratio (DSCR)</i> , <i>loan life coverage ratio (LLCR)</i> , <i>project life coverage ratio (PLCR)</i> , and <i>debt-to-equity ratio</i>)	Strong financial ratios considering the level of project risk; very robust economic assumptions	Strong to acceptable financial ratios considering the level of project risk; robust project economic assumptions	Standard financial ratios considering the level of project risk	Aggressive financial ratios considering the level of project risk
Stress analysis	The project can meet its financial obligations under sustained, severely stressed economic or sectoral conditions	The project can meet its financial obligations under normal stressed economic or sectoral conditions. The project is only likely to default under severe economic conditions	The project is vulnerable to stresses that are not uncommon through an economic cycle, and may default in a normal downturn	The project is likely to default unless conditions improve soon

	Strong	Good	Satisfactory	Weak
<i>Financial structure</i>				
Duration of the credit compared to the duration of the project	Useful life of the project significantly exceeds tenor of the loan	Useful life of the project exceeds tenor of the loan	Useful life of the project exceeds tenor of the loan	Useful life of the project may not exceed tenor of the loan
Amortisation schedule	Amortising debt	Amortising debt	Amortising debt repayments with limited bullet payment	Bullet repayment or amortising debt repayments with high bullet repayment
Political and legal environment				
Political risk, including transfer risk, considering project type and mitigants	Very low exposure; strong mitigation instruments, if needed	Low exposure; satisfactory mitigation instruments, if needed	Moderate exposure; fair mitigation instruments	High exposure; no or weak mitigation instruments
Force majeure risk (war, civil unrest, etc),	Low exposure	Acceptable exposure	Standard protection	Significant risks, not fully mitigated
Government support and project's importance for the country over the long term	Project of strategic importance for the country (preferably export-oriented). Strong support from Government	Project considered important for the country. Good level of support from Government	Project may not be strategic but brings unquestionable benefits for the country. Support from Government may not be explicit	Project not key to the country. No or weak support from Government
Stability of legal and regulatory environment (risk of change in law)	Favourable and stable regulatory environment over the long term	Favourable and stable regulatory environment over the medium term	Regulatory changes can be predicted with a fair level of certainty	Current or future regulatory issues may affect the project
Acquisition of all necessary supports and approvals for such relief from local content laws	Strong	Satisfactory	Fair	Weak

	Strong	Good	Satisfactory	Weak
Enforceability of contracts, collateral and security	Contracts, collateral and security are enforceable	Contracts, collateral and security are enforceable	Contracts, collateral and security are considered enforceable even if certain non-key issues may exist	There are unresolved key issues in respect if actual enforcement of contracts, collateral and security
Transaction characteristics				
<i>Design and technology risk</i>	Fully proven technology and design	Fully proven technology and design	Proven technology and design — start-up issues are mitigated by a strong completion package	Unproven technology and design; technology issues exist and/or complex design
<i>Construction risk</i>				
Permitting and siting	All permits have been obtained	Some permits are still outstanding but their receipt is considered very likely	Some permits are still outstanding but the permitting process is well defined and they are considered routine	Key permits still need to be obtained and are not considered routine. Significant conditions may be attached
Type of construction contract	Fixed-price date-certain turnkey construction EPC (engineering and procurement contract)	Fixed-price date-certain turnkey construction EPC	Fixed-price date-certain turnkey construction contract with one or several contractors	No or partial fixed-price turnkey contract and/or interfacing issues with multiple contractors
Completion guarantees	Substantial liquidated damages supported by financial substance and/or strong completion guarantee from sponsors with excellent financial standing	Significant liquidated damages supported by financial substance and/or completion guarantee from sponsors with good financial standing	Adequate liquidated damages supported by financial substance and/or completion guarantee from sponsors with good financial standing	Inadequate liquidated damages or not supported by financial substance or weak completion guarantees

	Strong	Good	Satisfactory	Weak
Track record and financial strength of contractor in constructing similar projects.	Strong	Good	Satisfactory	Weak
<i>Operating risk</i>				
Scope and nature of operations and maintenance (O & M) contracts	Strong long-term O&M contract, preferably with contractual performance incentives, and/or O&M reserve accounts	Long-term O&M contract, and/or O&M reserve accounts	Limited O&M contract or O&M reserve account	No O&M contract: risk of high operational cost overruns beyond mitigants
Operator's expertise, track record, and financial strength	Very strong, or committed technical assistance of the sponsors	Strong	Acceptable	Limited/weak, or local operator dependent on local authorities
<i>Off-take risk</i>				
(a) If there is a take-or-pay or fixed-price off-take contract:	Excellent creditworthiness of off-taker; strong termination clauses; tenor of contract comfortably exceeds the maturity of the debt	Good creditworthiness of off-taker; strong termination clauses; tenor of contract exceeds the maturity of the debt	Acceptable financial standing of off-taker; normal termination clauses; tenor of contract generally matches the maturity of the debt	Weak off-taker; weak termination clauses; tenor of contract does not exceed the maturity of the debt
(b) If there is no take-or-pay or fixed-price off-take contract:	Project produces essential services or a commodity sold widely on a world market; output can readily be absorbed at projected prices even at lower than historic market growth rates	Project produces essential services or a commodity sold widely on a regional market that will absorb it at projected prices at historical growth rates	Commodity is sold on a limited market that may absorb it only at lower than projected prices	Project output is demanded by only one or a few buyers or is not generally sold on an organised market

	Strong	Good	Satisfactory	Weak
<i>Supply risk</i>				
Price, volume and transportation risk of feed-stocks; supplier's track record and financial strength	Long-term supply contract with supplier of excellent financial standing	Long-term supply contract with supplier of good financial standing	Long-term supply contract with supplier of good financial standing — a degree of price risk may remain	Short-term supply contract or long-term supply contract with financially weak supplier — a degree of price risk definitely remains
Reserve risks (e.g. natural resource development)	Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project	Independently audited, proven and developed reserves in excess of requirements over lifetime of the project	Proven reserves can supply the project adequately through the maturity of the debt	Project relies to some extent on potential and undeveloped reserves
Strength of Sponsor				
Sponsor's track record, financial strength, and country/sector experience	Strong sponsor with excellent track record and high financial standing	Good sponsor with satisfactory track record and good financial standing	Adequate sponsor with adequate track record and good financial standing	Weak sponsor with no or questionable track record and/or financial weaknesses
Sponsor support, as evidenced by equity, ownership clause and incentive to inject additional cash if necessary	Strong. Project is highly strategic for the sponsor (core business — long-term strategy)	Good. Project is strategic for the sponsor (core business — long-term strategy)	Acceptable. Project is considered important for the sponsor (core business)	Limited. Project is not key to sponsor's long-term strategy or core business
Security Package				
Assignment of contracts and accounts	Fully comprehensive	Comprehensive	Acceptable	Weak

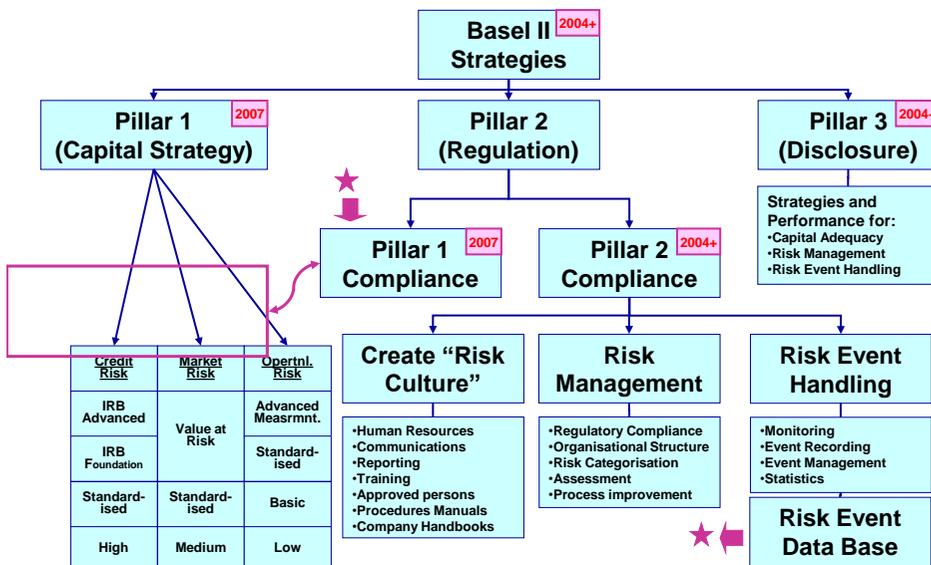
	Strong	Good	Satisfactory	Weak
Pledge of assets, taking into account quality, value and liquidity of assets	First perfected security interest in all project assets, contracts, permits and accounts necessary to run the project	Perfected security interest in all project assets, contracts, permits and accounts necessary to run the project	Acceptable security interest in all project assets, contracts, permits and accounts necessary to run the project	Little security or collateral for lenders; weak negative pledge clause
Lender's control over cash flow (e.g. cash sweeps, independent escrow accounts)	Strong	Satisfactory	Fair	Weak
Strength of the covenant package (mandatory prepayments, payment deferrals, payment cascade, dividend restrictions...)	Covenant package is strong for this type of project Project may issue no additional debt	Covenant package is satisfactory for this type of project Project may issue extremely limited additional debt	Covenant package is fair for this type of project Project may issue limited additional debt	Covenant package is insufficient for this type of project Project may issue unlimited additional debt
Reserve funds (debt service, O&M, renewal and replacement, unforeseen events, etc)	Longer than average coverage period, all reserve funds fully funded in cash or letters of credit from highly rated bank	Average coverage period, all reserve funds fully funded	Average coverage period, all reserve funds fully funded	Shorter than average coverage period, reserve funds funded from operating cash flows

Basel II: New Challenges for the Financial Services Sector: Operational Risk in Practice

PRESENTED BY:
KEITH CHECKLEY FCIB

1

Basel II in Summary



Ref: BIS 7.04

2

The Second Pillar – Supervisory Review Process



Importance of Supervisory Review:

- The supervisory review process of the Framework is intended not only to ensure that banks have adequate capital to support all the risk in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks.

3

Importance of Supervisory Review



- The supervisory review process recognises the responsibility of bank management in developing an internal capital assessment process and setting capital targets that are commensurate with the bank's risk profile and control environment.
- In the Framework, bank management continues to bear responsibility for ensuring that the bank has adequate capital to support its risks beyond the core minimum requirements.

4

Importance of Supervisory Review

- Supervisors are expected to evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate.
- This interaction is intended to foster an active dialogue between banks and supervisors, such that when deficiencies are identified, prompt and decisive action can be taken to reduce risk or restore capital.
- Accordingly supervisors may wish to adopt an approach to focus more intensely on those banks with risk profiles or operational experience that warrants such attention.

5

Importance of Supervisory Review

- Increased capital should not be viewed as the only option for addressing increased risks confronting the bank.
- Other means for addressing risk, such as strengthening risk management, applying internal limits, strengthening the level of provisions and reserves and improving internal controls, must also be considered.
- Furthermore, capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management processes.

6

Importance of Supervisory Review

- Particular focus can be directed towards risks that are not fully captured by the Pillar 1 process (e.g. credit concentration risk); those factors not taken into account by the Pillar 1 process (e.g. interest rate risk in the banking book, business and strategic risk); and factors external to the bank (e.g. business cycle effects).
- The assessment of compliance with the minimum standards and disclosure requirements of the more advanced methods in Pillar 1, in particular the IRB framework for credit risk and the Advanced Measurement Approaches for operational risk.

7

Four Key Principles of Supervisory Review

Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

Principle 2: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action, if they are not satisfied with the result of this process.

8

Four Key Principles of Supervisory Review



Principle 3: Supervisors should expect banks to operate above the minimum capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

9

The Third Pillar – Market Discipline General Considerations



Disclosure requirements:

- The Committee believes that the rationale for Pillar 3 is sufficiently strong to warrant the introduction of disclosure requirements for banks using the Framework.
- Supervisors have an array of measures that they can use to require banks to make such disclosures. Some of these disclosures will be qualifying criteria for the use of particular methodologies or the recognition of particular instruments and transactions.

10

The Third Pillar – Market Discipline General Considerations

Guiding principles:

- The purpose of Pillar 3 – market discipline is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2).
- The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution.

11

The Third Pillar – Market Discipline General Considerations

- The Committee believes that such disclosures have particular relevance under the Framework, where reliance on internal methodologies gives banks more discretion in assessing capital requirements.
- In principle, banks disclosures should be consistent with how senior management and the board of directors assess and manage the risks of the bank.

12

The Third Pillar – Market Discipline General Considerations

- Under Pillar 1, banks use specified approaches/ methodologies for measuring the various risks they faced and the resulting capital requirements.
- The Committee believes that providing disclosures that are based on this common framework is an effective means of informing the market about a bank's exposure to those risks and provides a consistent and understandable disclosure framework that enhances comparability.

13

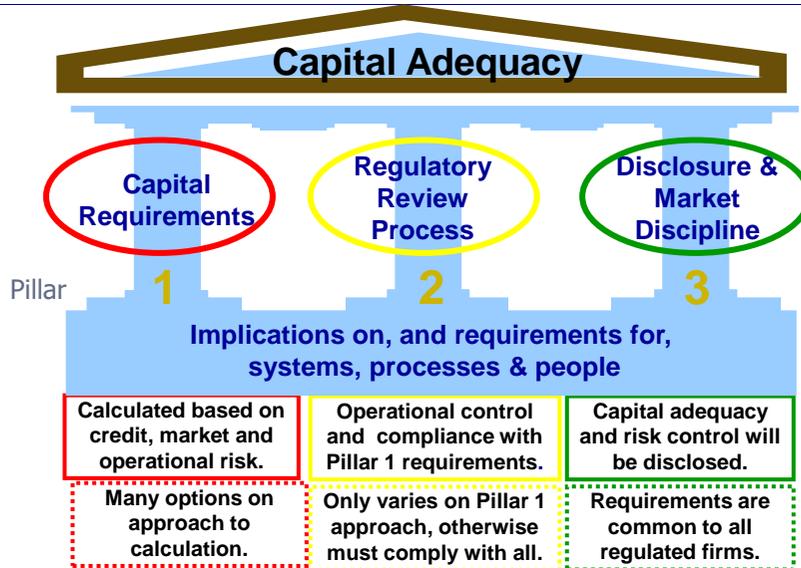
Disclosure Requirements

General Disclosure Principle:

- Banks should have a formal disclosure policy approved by the board of directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process.
- In addition, banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency of them.

14

Recap-BASEL II Overview



15

Operational Risk Overview

- Definition & analysis of operational risk
- Types of operational risk events
- An operational risk management framework
- Case Studies

16

Definition-Basel II



- Operational risk:
“the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events”
- Includes legal risk
- Excludes strategic & reputational risk

17

Basel Committee - Key Considerations



- Operational risk is an independent risk category that must be backed by regulatory capital
- The management of operational risk involves the identification, assessment, monitoring and control/mitigation of risk
- The most important types of operational risks involve breakdowns in internal controls & corporate governance

18

Examples of Operational Risk

Institution	Offense
BCCI	Illegal activities
Barings	Rogue trader & incompetence
Daiwa Bank	Rogue trader
Morgan Grenfell	Unauthorised investments
Long Term Capital Management	Errors in derivatives model
Equitable Life	Non-respect of guaranteed annuities
Cantor Fitzgerald	Terrorist attack
Allied Irish Bank	Rogue trader
Merrill Lynch	Biased analyst recommendations

19

Causes of Operational Risk

- **Processes:**
 - execution error
 - product complexity
 - booking error
 - settlement error
 - exceeding limits
 - model/methodology error
 - mark-to-model error
 - etc
- **External events:**
 - natural disaster
 - terrorist attack
 - etc
- **People:**
 - incompetence
 - fraud
 - etc
- **Systems:**
 - programming error
 - system failure
 - telecommunications failure
 - etc

20

Operational Risk Loss Event Types

- Internal fraud
- External fraud
- Employment practices & workplace safety
- Clients, products and business practices
- Damage to physical assets

21

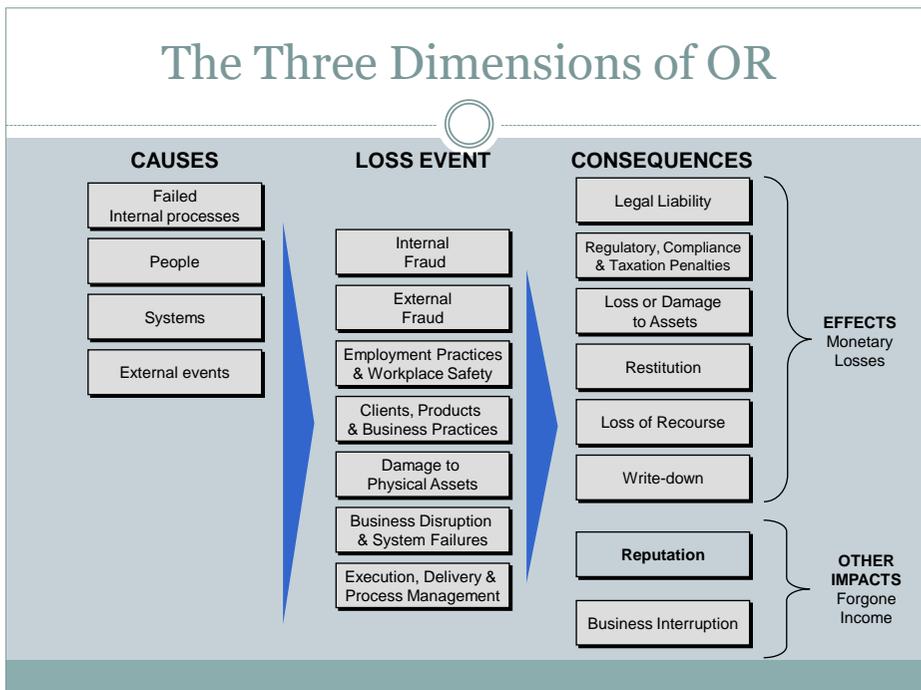
Operational Risk Loss Event Types

- Business disruption & systems failure
- Execution, delivery & process management

All have the potential to result in substantial losses

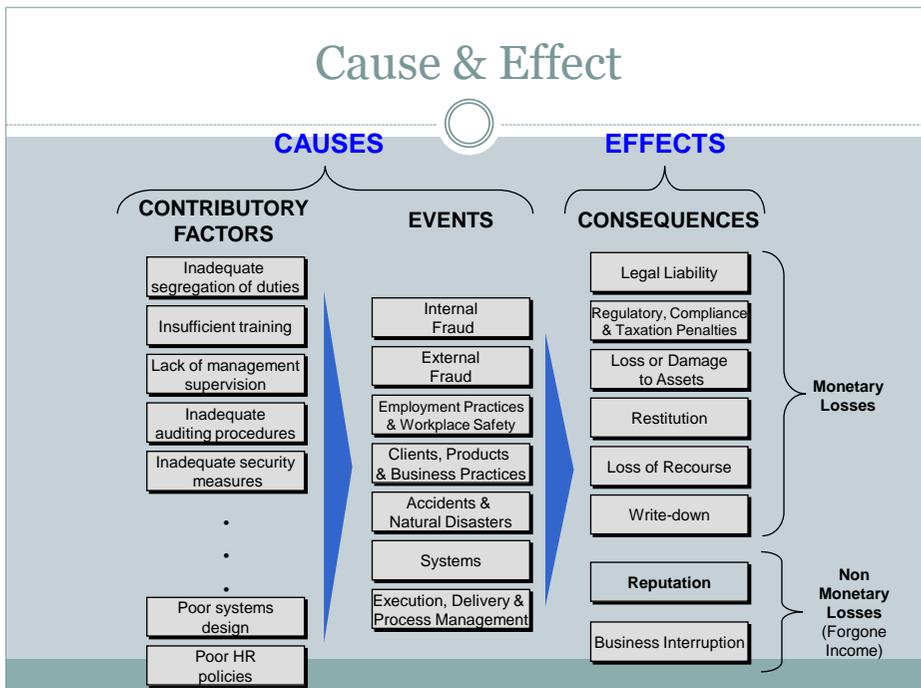
22

The Three Dimensions of OR



23

Cause & Effect



24

Operational Risk Management Framework



- “Sound Practices for the Management and Supervision of Operational Risk” (February 2003)
- Basel Committee develops risk principles around four themes

25

Theme 1: Developing an Appropriate RM Environment



- Principle 1:
 - Board responsibility
- Principle 2:
 - subject to effective, comprehensive & independent internal audit
- Principle 3:
 - senior management is responsible for implementing the OR management framework approved by the Board
 - consistent implementation throughout
 - all levels of staff should understand their responsibilities

26

Theme 2: RM Identification, Assessment, Monitoring and Mitigation/Control

- Principle 4:
 - need to identify & assess the OR inherent in all material products, activities, processes & systems
 - assessment before new products etc are introduced
- Principle 5:
 - a process for regular monitoring
 - regular reporting to senior management & the Board

27

Theme 2: RM Identification, Assessment, Monitoring and Mitigation/Control

- Principle 6:
 - policies, processes & procedures to control/mitigate material OR
 - these should be periodically reviewed
- Principle 7:
 - contingency & business continuity plans needed

28

Theme 3: Role of Supervisors



- Principle 8:
 - should require that all banks, regardless of size, have an effective OR framework
- Principle 9:
 - should conduct regular independent evaluation
 - should ensure appropriate mechanisms to enable them to remain appraised of developments at banks
- Principle 10:
 - banks should make sufficient public disclosure to allow market participants to assess their approach to OR management

29

Quantifying the Capital Charge



- Key Issues
- Measurement methodologies
- Qualifying criteria
- AMA primer
- Exercise

30

Key Issues

- A choice of methods:
 - Basic Indicator Approach
 - (alternative) Standardised Approach
 - Advanced Measurement Approaches
- Each is increasingly sophisticated & risk sensitive
- Choice is up to management BUT has to be approved by the supervisor

31

Basic Indicator Approach (BIA)

- Indicator is annual gross income – i.e. net interest income plus net non-interest income
- Bank must hold capital for operational risk equal to the average over the previous 3 years of a fixed % (alpha) of positive annual gross income
- Alpha is 15% - set by the Committee

32

Issues concerning the BIA

- The default position – no conditions, other than market entry, prescribed
- Not appropriate for internationally active banks & those with significant operational risk exposures
- It is not risk sensitive – gross income is an indicator of size, not risk
- If used in isolation, it is likely to produce a high capital charge – this is the only incentive for better risk management

33

Standardised Approach (STA)

- Banks' activities are divided into 8 business lines
- Gross income within each business line is the indicator
- Capital charge for each business line is:
gross income @ factor (beta) assigned by the Committee
- Total capital charge is the 3 year average of the summation of the capital charges across each of the business lines in each year

34

Beta Values Set by the Committee

BUSINESS LINES	BETA FACTORS
Corporate finance	18%
Trading & sales	18%
Retail banking	12%
Commercial banking	15%
Payment & settlement	18%
Agency services	15%
Asset management	12%
Retail brokerage	12%

35

Alternative Standardised Approach (ASA)

- Identical to the standardised approach except for 2 business lines - retail banking and commercial banking
- The total drawn amounts of loans and advances replaces gross income as the indicator for these business lines
- A fixed factor of 0.035 (“m”) is applied to loans and advances, the beta factor is also applied unchanged
- The total capital charge is the three year average of the business lines

36

Differences between BIA & STA

- STA is more sophisticated and is likely to lead to a lower capital charge
- STA is appropriate for a well-run & well-managed institution
- Regulators will expect the institution to:
 - identify its OR exposures & assess its potential impact
 - monitor & report its OR (ongoing)
 - create proper incentives by factoring OR into its overall business strategy

37

Advanced Measurement Approaches (AMA)

- No set approach
- Regulatory capital requirement = the risk measure generated by the bank's internal OR measurement system using quantitative & qualitative criteria
- There are stringent criteria attached, including the need to have a loss-event database going back at least 3 years
- AMA is subject to supervisory approval
- Appropriate for internationally active banks

38

Benefits of AMA

- Industry best practice
- The prospect of lower capital charges
- The use of risk mitigation – insurance. This is limited to 20% of the total OR capital charge and subject to qualifying criteria e.g.
 - insurance provider has a minimum claims paying ability rating of A
 - policy must have an initial term of not less than one year
 - insurance is provided by a third party entity

39

Qualifying Criteria – STA (1)

- Minimum requirements:
 - Board & senior management are actively involved in oversight of the OR framework
 - OR management system is conceptually sound & is implemented with integrity
 - sufficient resources in the use of the approach in the major business lines (as well as in the control & audit areas)
- Must develop specific policies and have documented criteria for mapping gross income into the standardised framework

40

Qualifying Criteria – STA (2)



- Internationally active banks must have adequate OR management systems
- They are subject to additional criteria:
 - an OR function with clear responsibilities
 - systematically track OR data by business line
 - OR assessment system closely integrated into RM processes & its output must be an integral part of process of monitoring & controlling bank's operational risk profile
 - techniques for creating incentives to improve throughout the firm

41

Qualifying Criteria – STA (3)



- regular reporting of OR exposures
- OR management system must be well documented
- validation & independent review (to include business units & OR management function)
- regular review by external auditors and/or supervisors

42

Qualifying Criteria – AMA (1)



- As for STA (minimum standards & qualitative standards) PLUS.....
- “a bank’s internal measurement system must reasonably estimate unexpected losses based on the combined use of internal and relevant external loss data, scenario analysis and bank-specific business environment and internal control factors”

43

Qualifying Criteria – AMA (2)



- AMA soundness standard. Whatever approach is used a bank must be able to demonstrate:
 - it captures potentially severe “tail” loss events
 - it meets a soundness standard comparable to IRB approach for credit risk (a one year holding period and a 99.9% confidence level)

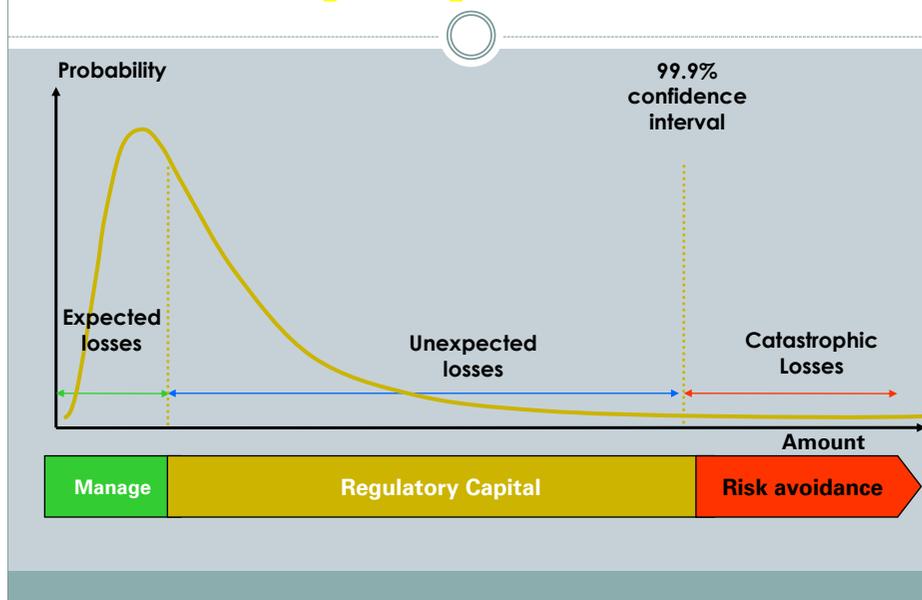
44

Qualifying Criteria – AMA (3)

- Regulatory capital is the sum of expected loss (EL) and unexpected loss (UL) UNLESS the bank can demonstrate that it is adequately capturing EL in its internal business practices
- If the bank can demonstrate to the satisfaction of the supervisor that it has measured and accounted for its EL exposure, it can base regulatory capital requirement on UL alone

45

Example: Operational risk



46

Issues Concerning AMA



- Will require significant investment
- Incentive = lower capital charges
- Must be co-ordinated project – rooted in loss experience
- Data for high impact low probability events is scarce
- Will test the supervisor

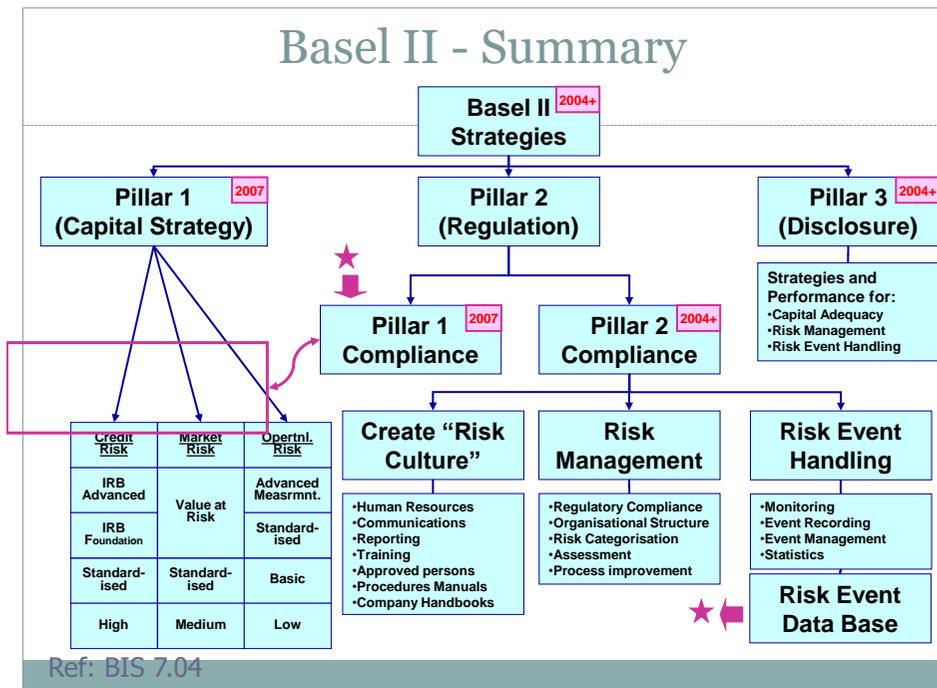
47

Comments On Pillar 1



- Use the method most appropriate to your organisation
- No agreed AMA approach yet
- Don't view Pillar 1 in isolation – all 3 pillars are equally important and complementary

48



49

Some suggestions to Financial Institutions

- Know your local regulatory requirements
- All three pillars must be considered together
- Cost/benefit is the key
- Consider simple solutions first
- Operational risk is more than compliance, it is a business requirement
- Culture will be a key area
- Start now !

50



Investment & Liquidity Risks



The Commonwealth of The Bahamas

1



Investment & Liquidity Risks (Module III)

Jermaine J. Williams JP, CBMBA, MCIBS, BSAc, CAMS, CIRM, CCP
Bahamas Institute of Financial Services (BIFS)
Certified International Risk Management

March 2021



2

Enterprise-wide Risk Management



3

Investment Risk



Investment risk can be defined as the probability or likelihood of occurrence of losses relative to the expected return on any particular investment.

4

4

Types of Investment Risk

- **Interest Rate Risk**

Interest rate risk is the possibility that a fixed-rate debt instrument will decline in value as a result of a rise in interest rates. Whenever investors buy securities that offer a fixed rate of return, they are exposing themselves to interest rate risk.

- **Business Risk** (*unsystematic risk*)

The risk associated with a specific issuer of a security. Business risk refers to the possibility that the issuer of a stock or a bond may go bankrupt or be unable to pay the interest or principal. A common way to avoid unsystematic risk is to diversify.

- **Credit Risk**

A credit risk is the risk of default on a debt that may arise from a borrower failing to make required payments.

5

5

Types of Investment Risk

- **Taxability Risk**

The risk that a security that was issued with tax-exempt status could potentially lose that status prior to maturity.

- **Call Risk**

Call risk is specific to bond issues and refers to the possibility that a debt security will be called prior to maturity.

- **Inflationary Risk** (*purchasing power risk*)

The chance that the value of an asset or income will be eroded as inflation shrinks the value of a country's currency. It is the risk that future inflation will cause the purchasing power of cash flow from an investment to decline.

- **Liquidity Risk**

Risks that a company or bank may be unable to meet short term financial demands. The inability to convert a security or hard asset to cash without a loss of capital and/or income.

6

6

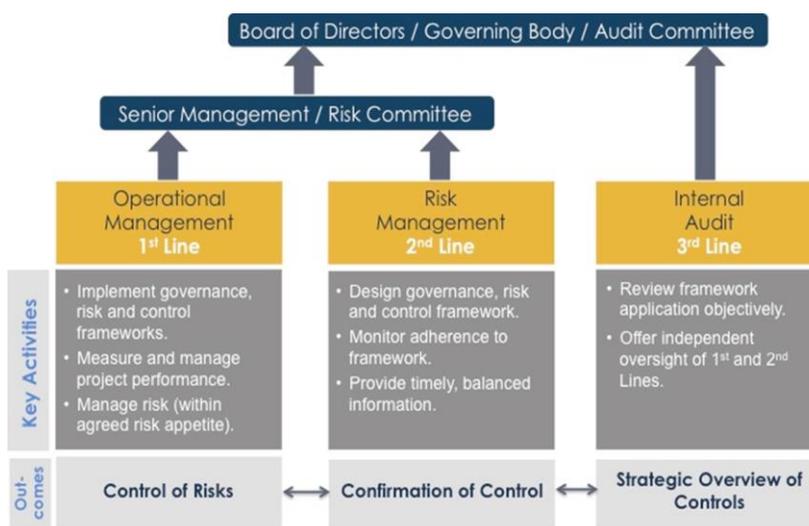
Types of Investment Risk

- Market Risk (systematic risk)**
 The risk of inherent uncertainty; market volatility or undiversifiable risk.
- Social/Political / legislative Risk**
 Risks associated with the possibility of nationalization, unfavorable government action or social changes resulting in a loss of value is called **social or political risk**; to change laws affecting securities, any ruling that results in adverse consequences is also known as **legislative risk**.
- Currency/Exchange Rate Risk**
 A form of risk that arises from the change in price of one currency against another. The constant fluctuations in the foreign currency in which an investment is denominated vis-à-vis one's home currency may add risk to the value of a security.
- Reinvestment Risk**
 Risk that falling interest rates will lead to a decline in cash flow from an investment when its principal and interest payments are reinvested at lower rates.

7

7

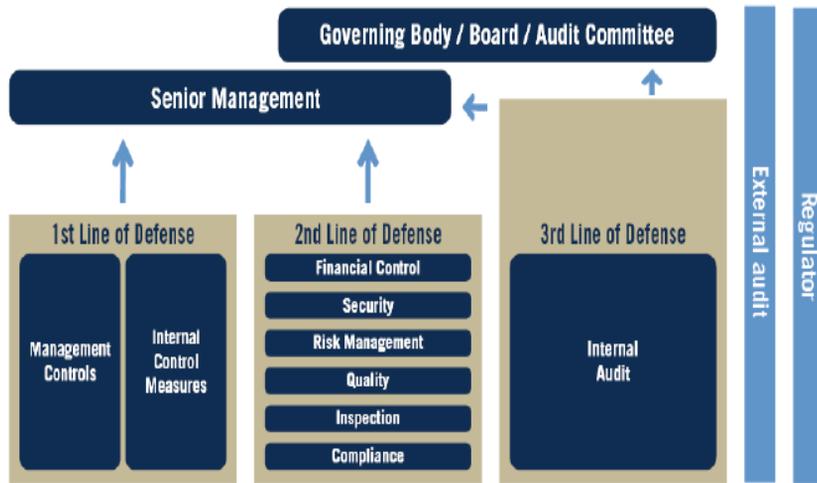
Governance & Risk Mgmt.



8

8

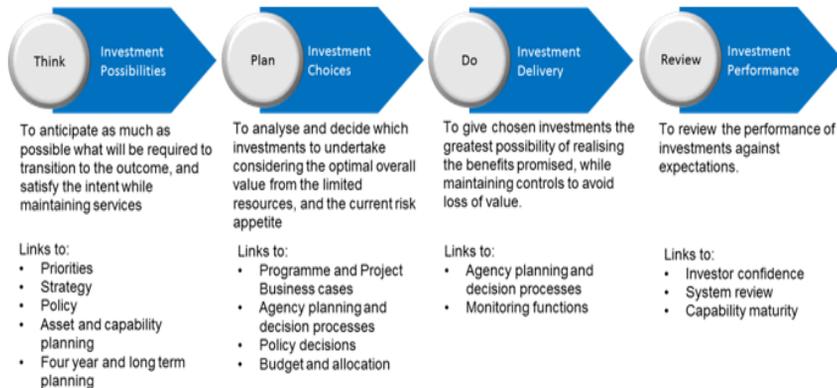
Governance & Risk Mgmt.



9

9

Individual Investor Life Cycle



10

Individual Investor Life Cycle

- **Accumulation phase** – early to middle years of working career.
- **Consolidation phase** – past midpoint of careers. Earnings greater than expenses.
- **Spending/Gifting phase** – begins after retirement.

11

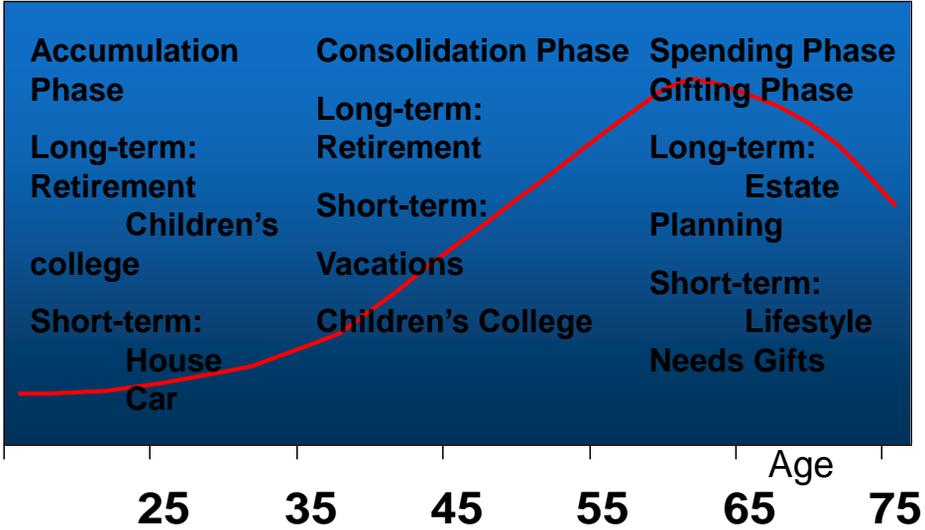
Age 20-39	Age 40-59	Age 60-69	Age 70-79	Age 80 - X
LIFECYCLE				
Early earning years	Peak earnings	Declining earnings	No earnings	No earnings
Building a career	Established within career	Phased retirement	Full retirement	Long-term care
Marriage & Family	Aging parents	Active lifestyle	Maintain lifestyle	Assisted living
Mortgage & debt	Children's marriage	Vacation home/boat	Health issues	Death of spouse
WEALTH CYCLE				
Aggressive growth	Capital appreciation	Capital preservation	Protect wealth	Protect wealth
Long-term growth	Maximize contributions	Manage market risk	Manage cash flow	Long-term care
Manage debt	Retirement Planning	Estate planning	Meet obligations	Transfer estate
Pay off loans	College savings	Charitable activities	Manage health care costs	Charitable giving

12

12

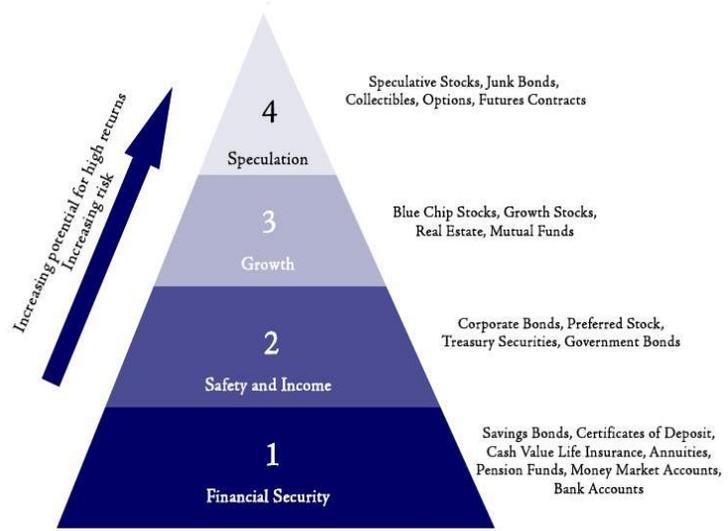
Individual Investor Life Cycle

Net Worth



13

Investment Risk Pyramid



14

14

The Portfolio Management Process



15

The Portfolio Management Process

1. Policy statement

- specifies investment goals and acceptable risk levels
- should be reviewed periodically
- guides all investment decisions

2. Study current financial and economic conditions and forecast future trends

- determine strategies to meet goals
- requires monitoring and updating

3. Construct the portfolio

- allocate available funds to minimize investor's risks and meet investment goals

4. Monitor and update

- evaluate portfolio performance
- Monitor investor's needs and market conditions
- revise policy statement as needed
- modify investment strategy accordingly



16

The Need For A Policy Statement

- Helps investors understand their own needs, objectives, and investment constraints.
- Sets standards for evaluating portfolio performance.
- Reduces the possibility of inappropriate behavior on the part of the portfolio manager.

17

Constructing A Policy Statement

Questions:

- What are the real risks of an adverse financial outcome, especially in the short run?
- What probable emotional reactions will I have to an adverse financial outcome?
- How knowledgeable am I about investments and the financial markets?



18

Constructing A Policy Statement

- What other capital or income sources do I have? How important is this particular portfolio to my overall financial position?
- What, if any, legal restrictions may affect my investment needs?
- What, if any, unanticipated consequences of interim fluctuations in portfolio value might affect my investment policy?



19

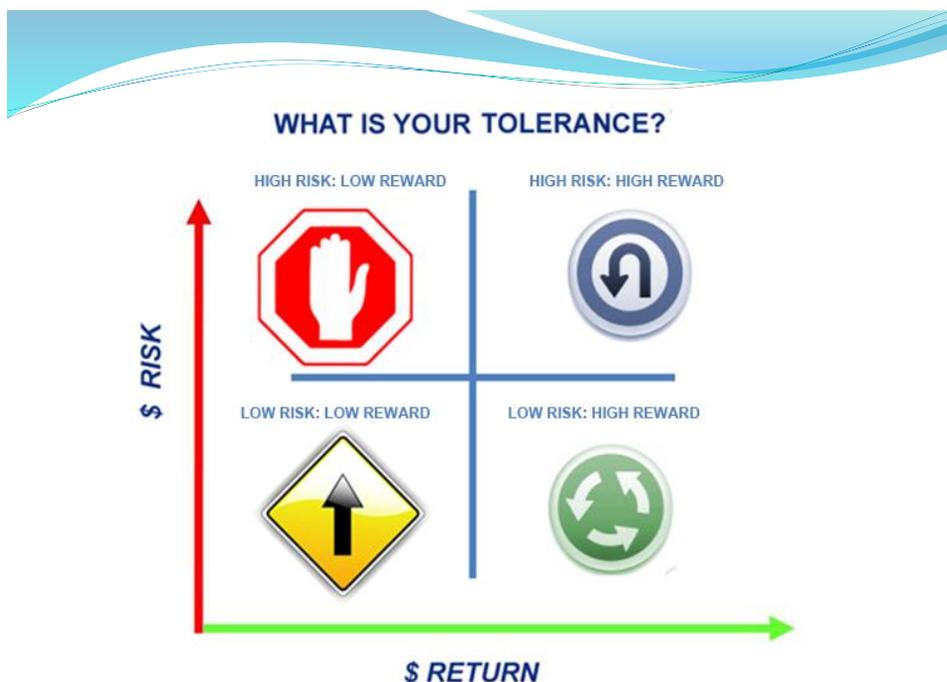
Investment Risk Tolerance

Risk tolerance is the degree of variability in investment returns that an investor is willing to withstand: *Aggressive, Moderate and Conservative Risk Tolerance*.

- **Aggressive Risk Tolerance**
Aggressive investors tend to be market-savvy. Aggressive investors reach for maximum returns with maximum risk. (*Risk Seeking/Risk Lover*)
- **Moderate Risk Tolerance**
Moderate investors accept some risk to principal but adopt a balanced approach with intermediate term time horizons. (*Risk Neutral/Risk Acceptant*)
- **Conservative Risk Tolerance**
Conservative investors are willing to accept little to no volatility in their investment portfolios. (*Risk Averse*)

20

20



21

21

Investment Objectives

- **Trade-off between risk and expected return =**
should include both risk and return objectives
- **Factors affecting investor tolerance:**
 - Psychological factors
 - Economic factors

22

Investment Objectives

Psychological factors/Personal Factors cont'd:

Psychological factors mean thoughts, feelings, and other cognitive characteristics that influence the behavior, attitude, and functions of the person mind. These psychological factors can effect on human thinking and afterward they also affect his decision-making and relationships in daily life. Psychologist describes individual investor behavior by keeping focus on person's personality or his characteristics.

Overconfidence

- Overconfidence means when someone has more confidence in his/her abilities about some situation. They misjudge their abilities, knowledge, skills, and availability of information.

Optimism

- Optimism means that all will be better than the examination. It originates from overconfidence. People have positive feelings about everything. They hope for the good more than the actual. Investors think that market will go high in the future but this can't be happen all the time.

Fear of loss

- People are afraid of losing. Investors do not want to bear loss.

23

Investment Objectives

Psychological factors/Personal Factors:

Herd behavior

- Investors discuss about their investment with their relatives, friends, co-workers etc. and want to act on it.

Positive attitude

- Some investors are confident about their decision-making. They think they should take risk in order to earn more profits than others.

Consultancy effect

- Investors are very conscious about their investment, they discuss and take advices from brokers in order to minimize risk on their investment.

Cognitive bias

- Cognitive bias means that when a person obtains some information, he processes it by filtering through his/her own experience, thoughts, likes, and dislikes. Simply cognitive psychology (a part of behavior finance) tells how people think.

24

Investment Objectives

Economic Factors:

Economic factors consist of the information that can affect the worth or value of a business or an investment. Economic factors can be those which you bear in your mind after manipulating or calculating the present and expected future value of an investment portfolio or any kind of business.

Overall performance of company

- It means the analysis of a company's performance that how a company meets its goals and objectives. It includes three (3) things: *Financial Performance, Market Performance & Shareholder.*

Price movement information

- It means change or fluctuation in prices because of difference in demand and supply in a trading day.

Risk aversion

- Risk is uncertainty about their investment that whether it will give them profit or loss. Every investor takes risk according to his/her investment objectives.

25

Investment Objectives

Economic Factors cont'd:

Risk taking capacity

- Risk is uncertainty about their investment that whether it will give them profit or loss. Investor invests in volatile investment in order to get higher profits than average. Investors who want to generate higher return will invest in the securities with high risk, while risk avoiding investors will invest in securities with low risk hence results in low profits: there are three (3) important determinant of risk taking behavior can be **Risk attitude, Beliefs and Risk Perception.**

Profitability

- When investors invest their money, their main purpose is to earn profit on it. They do not hesitate to invest on risky securities because they think that high risk can give them high returns. Level of annual earning/income and the savings affects the decision-making of investor.

26

Investment Objectives

General Goals

- **Capital preservation**
 - minimize risk of real loss
- **Capital appreciation**
 - Growth of the portfolio in real terms to meet future need.
- **Current income**
 - Focus is in generating income rather than capital gains.
- **Total return**
 - Increase portfolio value by capital gains and by reinvesting current income.
 - Maintain moderate risk exposure

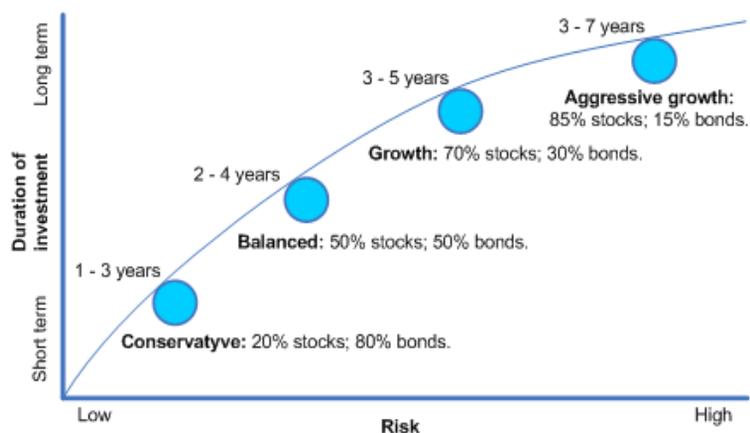
27

Investment Constraints

- **Liquidity needs**
 - Vary between investors depending upon age, employment, tax status, etc.
- **Time horizon**
 - Influences liquidity needs and risk tolerance.
- **Tax concerns**
 - Must look at after tax returns, affected by rates on income (dividends) and capital gains.

28

Investment Constraints



29

Investment Constraints

- **Legal and regulatory factors**
 - Apply more to institutional investors, but also affect individual
 - Limitations or penalties on withdrawals
 - Fiduciary responsibilities - “prudent man” rule
 - Investment laws prohibit insider trading

30

Investment Constraints

- **Unique needs and preferences**
 - Anything that does not fit into the above categories
 - Personal preferences such as socially conscious investments could influence investment choice
 - Time constraints or lack of expertise for managing the portfolio may require professional management
 - Large investment in employer's stock may require consideration of diversification needs
 - Institutional investors needs

31

Asset Allocation

- The process of dividing investment funds across different asset classes.
- **Asset class** – securities that have similar characteristics, attributes and risk/return relationships.
- **Diversification is an underlying principle:** reducing portfolio risk by adding asset classes/securities whose returns are not highly correlated.

32

Asset Allocation

An investment strategy is based on (4) four decisions

- What asset classes to consider for investment?
- What normal or policy weights to assign to each eligible class?
- Determining the allowable allocation ranges based on policy weights.
- What specific securities to purchase for the portfolio?

33

Asset Allocation

Various asset classes ranked in terms of riskiness

1. **Cash** : money market funds, commercial paper
2. **Bonds**: investment-grade, high yield, corporate government, short-term, intermediate, long-term, domestic, foreign, etc.
3. **Stock** : large cap, small cap, growth, value, domestic, international, emerging markets, etc.
4. **Other** – derivatives, commodities, currencies, real estate, etc.

34

Returns and Risk of Different Asset Classes

- Historically, small company stocks have generated the highest returns. But the volatility of returns have been the highest too.
- Inflation and taxes have a major impact on returns.
- Returns on Treasury Bills have barely kept pace with inflation.

35

Returns and Risk of Different Asset Classes

- Measuring risk by probability of **not** meeting your investment return objective indicates risk of equities is small and that of T-bills is large because of their differences in expected returns.
- Focusing only on return variability as a measure of risk ignores reinvestment risk

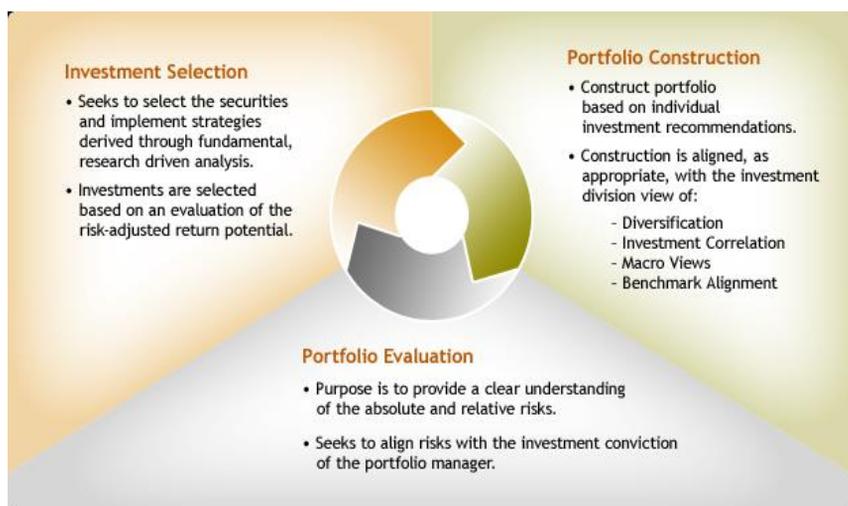
36

Asset Allocation Summary

- Policy statement determines types of assets to include in portfolio.
- Asset allocation determines portfolio return more than stock selection.
- Over long time periods, sizable allocation to equity will improve results.
- Risk of a strategy depends on the investor's goals and time horizon.

37

Portfolio Risk Management



38

38



Summary

- Identify investment needs, risk tolerance, and familiarity with capital markets
- Identify objectives and constraints
- Enhance investment plans by accurate formulation of a policy statement
- Focus on asset allocation as it determines long-term returns and risk

39



The Internet *Investments Online*

www.ssa.gov

www.ibbotson.com

www.mfea.com

www.mfea.com/planidx.html

www.asec.com

www.cccsedu.org/home.html

www.aimr.org

www.iafp.org

www.amercoll.edu

www.idfp.org

www.napfa.org

40

Banks

- Must attract funds in a competitive interest rate environment.
- Try to maintain a positive difference between their cost of funds and their return on assets.
- Need substantial liquidity to meet withdrawals and loan demands.
- Face regulatory constraints.

41

Investment Management

- What is an investment?
 - Current commitment of dollars for a period of time to derive future payments (returns) that will compensate for:
 1. the time the funds are committed
 2. the expected rate of inflation and
 3. the uncertainty of future payments
 - Expenditure of capital with the expectation of returns
- Returns = return of capital + return on capital

42

Investment Management

- How is risk defined?
 - Uncertainty of future outcomes
 - Volatility in returns
 - Probability of an adverse outcome (downside risk)
- What does it mean to be risk averse?
 - Investors prefer less risk to more risk, all else being equal, i.e.
 - When two investments have the same expected return, investors prefer the lower risk investment
 - When two investments have the same risk, investors prefer the investment with the higher expected return
- Risky asset – one whose return is not guaranteed

43

Investment Management

- Markowitz's Modern Portfolio Theory (MPT) – basis for measuring portfolio risk. Key concepts:
 1. Investors look at each investment as a **probability distribution** of expected returns
 2. Investors **measure risk as variance** (standard deviation) of expected returns (mean)
 3. Investor decisions consider only the **risk and return** of an investment opportunity
 4. Investors are **risk averse**

44

Investment Management

- MPT is the basis for diversification theory and measuring portfolio risk
- Under MPT, an investment is considered to be efficient if no other investment offers
 - higher expected return with the same (or lower) risk i.e. standard deviation
 - OR
 - lower risk with the same (or higher) expected return i.e. mean

45

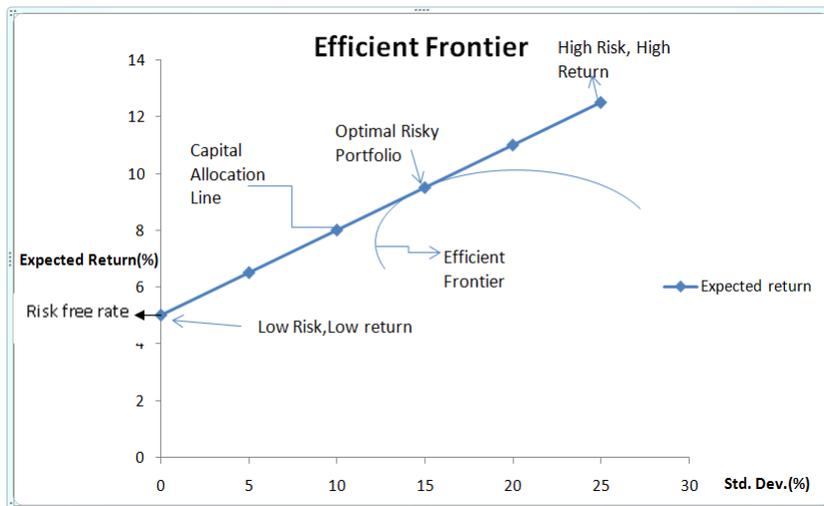
Investment Management

Which of the following portfolios cannot be efficient?

<u>Portfolio</u>	<u>Mean</u>	<u>Std. Dev.</u>
A	10%	12%
B	12%	16%
C	14%	15%

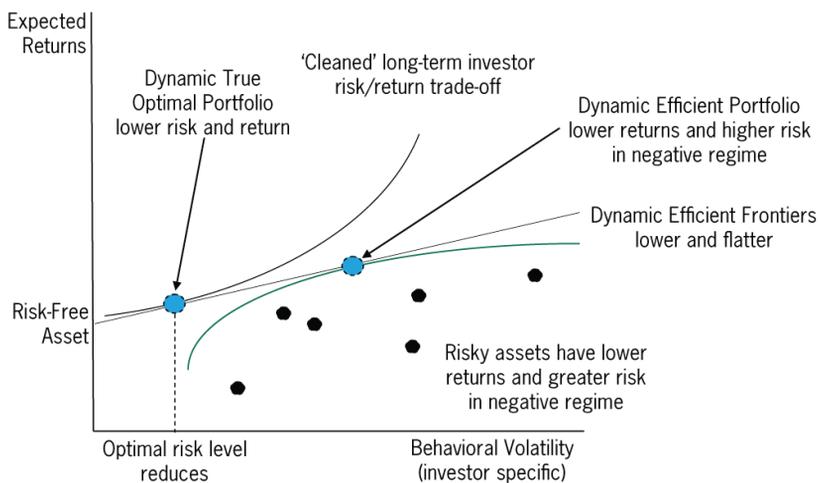
46

Return, Risk and Diversification



47

Return, Risk and Diversification



48

Return, Risk and Diversification

- Holding period return (HPR) – total return over a specific time period (usually 1 year)

$$\text{HPR} = \frac{[(P_1 - P_0) + \text{CF}]}{P_0}$$

where

P_0 = price at start of period

P_1 = price at end of period

CF = cash flow from investment (income)

Income = dividends and interest

49

Return, Risk and Diversification

- You buy 100 shares of Company X for \$15 each on 1 January and sell them for \$17.50 each on 31 December after receiving dividends of \$1 per share. What is your HPR?

$$\begin{aligned} \text{HPR} &= \frac{[(P_1 - P_0) + \text{CF}]}{P_0} \\ &= \frac{[(\$1,750 - \$1,500) + \$100]}{\$1,500} \\ &= 23.33\% \end{aligned}$$

50

Return, Risk and Diversification

- Annualized hold period return – used to calculate annual returns where holding period < 1 year

$$\text{Annualized HPR} = (1 + \text{HPR})^n - 1$$

where

HPR = HPR for the period

n = number of compounding periods

51

Return, Risk and Diversification

- What would HPR be if you sold your 100 shares in Company X (on slide 17) for \$16 each on 30 June and missed out on the dividend payment?

$$\begin{aligned} \text{HPR} &= \frac{[(P_1 - P_0) + \text{CF}]}{P_0} \\ &= \frac{[(\$1,600 - \$1,500)]}{\$1,500} = 6.67\% \end{aligned}$$

$$\begin{aligned} \text{Annualized HPR} &= (1 + \text{HPR})^n - 1 \\ &= (1 + 0.067)^2 - 1 = 13.78\% \end{aligned}$$

52

Return, Risk and Diversification

Basic calculation definitions

i/j = any given asset

port = any given
portfolio

P = probability

R = return

E(R) = expected return

X = value of an
observation

Σ = the sum of all
observations

μ = population mean

w = weight or
percentage

n = number of items in
a set

53

Return, Risk and Diversification

- Mean – expected return/expected outcome
- For a single asset:

$$\text{Mean} = \mu = (\Sigma \text{HPR})/n = (R_1 + R_2 + \dots + R_n)/n$$

OR

$$\text{Mean} = \mu = \sum P_i E(R_i)$$

where

P_i = probability of the return on asset i

$E(R_i)$ = expected return on asset i

54

Return, Risk and Diversification

Calculating the mean of a single asset:

Year 1	P_i	$E(R_i)$	$P_i E(R_i)$
Recession	0.20	-0.05	-0.01
Normal	0.60	0.10	0.06
Expansion	0.20	0.25	0.05
Mean = μ =			0.10
$\mu = \sum P_i E(R_i) = 10\%$			

55

Return, Risk and Diversification

- For a portfolio of assets:

$$\text{Mean}_{\text{port}} = \mu_{\text{port}} = \sum_{i=1}^n w_i R_i$$

where

i = any given asset

w_i = weight of asset i in the portfolio

R_i = return on asset i

56

Return, Risk and Diversification

Calculating the mean of a portfolio of assets:

Asset	w_i	R_i	$w_i R_i$
Stock A	0.25	9.0%	2.25%
Stock B	0.45	19.0%	8.55%
Stock C	0.30	13.0%	3.90%
Mean = μ =			14.70%
$\mu_{\text{port}} = w_A R_A + w_B R_B + w_C R_C$ $= \sum_{i=1}^n w_i R_i = 14.70\%$			

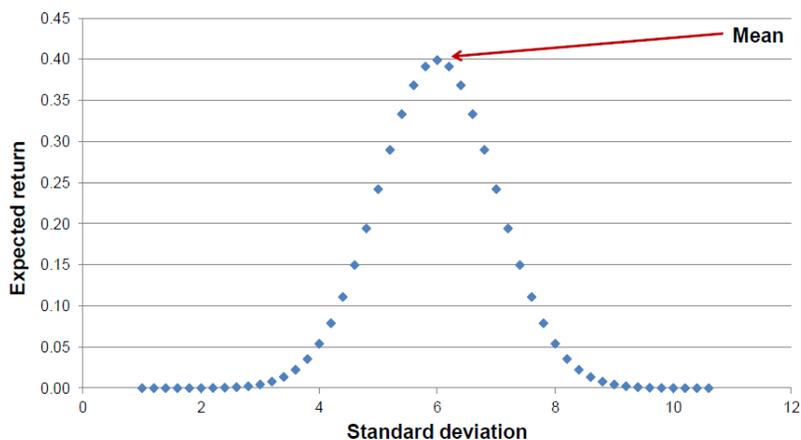
57

Return, Risk and Diversification

- Variance/standard deviation – measures the dispersion or spread of returns around an expected value (the mean)
- A low standard deviation indicates that the data points tend to be very close to the mean
- A high standard deviation indicates that the data is spread out over a large range of values around the mean
- Lower standard deviation = less volatility in returns = less risk

58

Return, Risk and Diversification

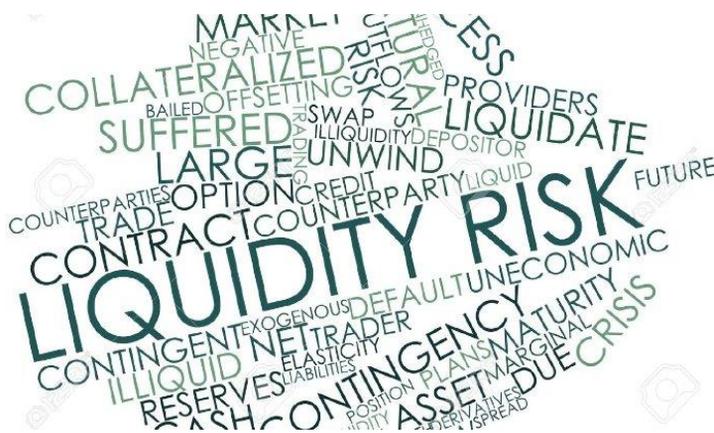


59

Sources:

- ***Investment Analysis and Portfolio Management***
Seventh Edition
by Frank K. Reilly & Keith C. Brown
- ***CFA Institute***
 - *Corporate Finance and Portfolio Management*,
CFA® Program Curriculum, Level I 2012, Volume 4
 - CFA® Level I Mock Exams, 2011, 2012, 2013, 2014
- **Other**
 - *Investment Analysis and Portfolio Management*,
4th Ed., Frank K. Reilly
 - *Portfolio Management*, CFA® Study Session 12,
Level I 2013, Schweser Kaplan

60



61

Agenda

- Overview
- Principles of Sound Liquidity Management
- Monitoring and Controls
- Application: Banking Industry



62

Liquidity Risk Management



63

63

Overview

Liquidity

- Ability to fund increases in assets and meet obligations as they come due, w/out incurring unacceptable losses (*Basel Committee*).
- Liquidity is a licensee's capacity to fund increases in assets or meet collateral obligations at a reasonable cost as they fall due, without incurring unacceptable losses. Maintaining an adequate level of liquidity depends on the licensee's ability to meet both expected and unexpected cash flows efficiently and collateral needs, without adversely affecting either daily operations or the financial condition of the licensee (*Central Bank of the Bahamas*).

64

Overview (cont'd)

Liquidity Risk

- Liquidity risk is the risk that a licensee's financial condition or **overall safety and soundness** is adversely affected by an inability—real or perceived—to meet its contractual obligations . A licensee's obligations and the funding sources used to meet them depend significantly on its business mix, balance sheet structure, and the cash-flow profiles of its on- and off-balance sheet obligations. (*Central Bank of the Bahamas*).
- The risk that the entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or other financial asset (*IFRS 7*).

65

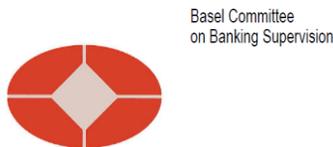
Overview (cont'd)

- Liquidity is the ability to fund increases in assets and meet obligations as they come due. Within this definition is an assumption that obligations will be able to be met “at reasonable cost”. Liquidity risk management seeks to ensure a bank's ability to continue to do this. This involves meeting uncertain cash flow obligations, which depend on external events and on other agents' behavior.

The fundamental role of banks in facilitating the maturity transformation of short-term deposits into long-term loans makes banks inherently vulnerable to liquidity risk, the risk that demands for repayment outstrip the capacity to raise new liabilities or liquefy assets (*Basel Committee*).

66

Overview (cont'd)



Basel Committee on Banking Supervision



Principles for Sound Liquidity Risk Management and Supervision

September 2008

The Central Bank of The Bahamas

Minimum Liquidity Requirements



SUPERVISORY AND REGULATORY GUIDELINES: PU68-0510
 Management of Liquidity Risk
 Issued: 25th March 2005
 Revised: 20th April 2012

GUIDELINES FOR THE MANAGEMENT OF LIQUIDITY RISK



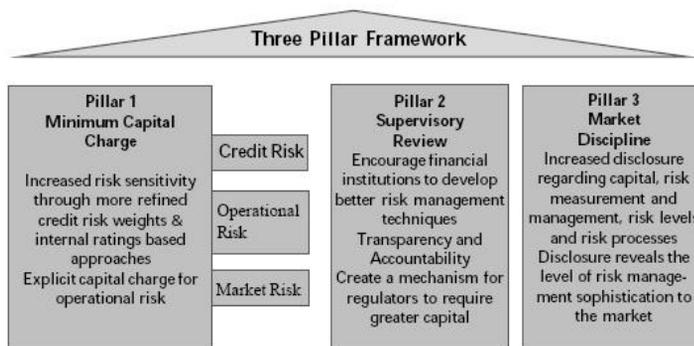
BANK FOR INTERNATIONAL SETTLEMENTS

67

Liquidity Risk Management

Governing Legislation

- **Basel III (or the Third Basel Accord)** - voluntary regulatory framework on bank capital adequacy, stress testing and market liquidity risk.



68

Principles of Sound Liquidity Management - *Basel Committee*

Fundamental principles for the management and supervision of liquidity risk

Principle 1: A bank is responsible for the **sound management** of liquidity risk. A bank should establish a **robust liquidity risk management framework** that ensures it maintains sufficient liquidity, including a cushion of unencumbered, high quality liquid assets, to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources.

Supervisors should assess the adequacy of both a bank's liquidity risk management framework and its liquidity position and should take prompt action if a bank is deficient in either area in order to **protect depositors** and to **limit potential damage to the financial system**.

69

Principles of Sound Liquidity Management (cont'd)

Governance of liquidity risk management

Principle 2: A bank should clearly articulate a **liquidity risk tolerance** that is appropriate for its business strategy and its role in the financial system.

Principle 3: Senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure that the bank maintains sufficient liquidity. Senior management should continuously review information on the bank's liquidity developments and report to the board of directors on a regular basis. **A bank's board of directors should review and approve the strategy, policies and practices related to the management of liquidity at least annually and ensure that senior management manages liquidity risk effectively.**

Principle 4: A bank should incorporate liquidity costs, benefits and risks in the internal pricing, performance measurement and new product approval process for all significant business activities (both on- and off-balance sheet), thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole.

70

Principles of Sound Liquidity Management (cont'd)

Measurement and management of liquidity risk

Principle 5: A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk. This process should include a robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons.

Principle 6: A bank should actively monitor and control liquidity risk exposures and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to the transferability of liquidity.

Principle 7: A bank should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. A bank should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid.

71

Principles of Sound Liquidity Management (cont'd)

Measurement and management of liquidity risk (cont'd)

Principle 8: A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems.

Principle 9: A bank should actively manage its collateral positions, differentiating between encumbered and unencumbered assets. A bank should monitor the legal entity and physical location where collateral is held and how it may be mobilized in a timely manner.

Principle 10: A bank should conduct stress tests on a regular basis for a variety of short-term and protracted institution-specific and market-wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity risk tolerance. A bank should use stress test outcomes to adjust its liquidity risk management strategies, policies, and positions and to develop effective contingency plans.

72

Principles of Sound Liquidity Management (cont'd)

Measurement and management of liquidity risk (cont'd)

Principle 11: A bank should have a **formal contingency funding plan (CFP)** that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should outline policies to manage a range of stress environments, establish clear lines of responsibility, include clear invocation and escalation procedures and be regularly tested and updated to ensure that it is operationally robust.

Principle 12: A bank should maintain a cushion of unencumbered, high quality liquid assets to be held as **insurance** against a range of liquidity stress scenarios, including those that involve the loss or impairment of unsecured and typically available secured funding sources. There should be no legal, regulatory or operational impediment to using these assets to obtain funding.

73

Principles of Sound Liquidity Management (cont'd)

Public disclosure

Principle 13: A bank should publicly disclose information on a regular basis that enables market participants to make an informed judgement about the soundness of its liquidity risk management framework and liquidity position.

The role of supervisors

Principle 14: Supervisors should regularly perform a comprehensive assessment of a bank's overall liquidity risk management framework and liquidity position to determine whether they deliver an adequate level of resilience to liquidity stress given the bank's role in the financial system.

Principle 15: Supervisors should supplement their regular assessments of a bank's liquidity risk management framework and liquidity position by monitoring a combination of internal reports, prudential reports and market information.

74

Principles of Sound Liquidity Management (cont'd)

The role of supervisors (cont'd)

Principle 16: Supervisors should intervene to require effective and timely remedial action by a bank to address deficiencies in its liquidity risk management processes or liquidity position.

Principle 17: Supervisors should communicate with other supervisors and public authorities, such as central banks, both within and across national borders, to facilitate effective cooperation regarding the supervision and oversight of liquidity risk management. Communication should occur regularly during normal times, with the nature and frequency of the information sharing increasing as appropriate during times of stress.

75

Liquidity Risk Management

Central Bank of the Bahamas

- **Effective corporate governance** consisting of oversight by the board of directors and active involvement by senior management in an institution's control of liquidity risk;
- **Appropriate strategies, policies, procedures, and limits** used to manage and mitigate liquidity risk;

76

Critical elements of sound liquidity risk management (Cont'd)

- **Comprehensive liquidity risk measurement and monitoring systems** (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the institution;
- Active management of intraday liquidity and collateral;
- An appropriately diverse mix of existing and potential future funding sources;

77

Critical elements of sound liquidity risk management (Cont'd)

- Adequate levels of **highly liquid marketable securities free of legal, regulatory, or operational impediments** that can be used to meet liquidity needs in stressful situations;
- **Internal controls and internal audit processes** sufficient to determine the adequacy of the institution's liquidity risk management process; and
- **Appropriate contingency funding plans (“CFPs”)** that sufficiently address potential adverse liquidity events to which the institution may be exposed and emergency cash flow requirements.

78

Liquidity Risk Monitoring & Control

Central Bank of the Bahamas:

Ratio and Limits:

- Target liquidity ratio
- Maturity mismatch limits for local and major foreign currencies;
- Concentration limits in respect of the mix of assets and liabilities
- Loan to deposit ratio or other ratios appropriate to a licensee's business activities

Pursuant to Regulation 6(1) of the LRMR and as detailed in paragraph 3.1 of these Guidelines, **every licensee shall maintain a liquidity ratio of not less than twenty (20) percent.**

Liquidity Ratio = $\frac{\text{Total Liquid Assets}}{\text{Total Deposit Liabilities}}$

79

Liquidity Risk Management



80

80

Liquidity Ratio:

- Bank X has liquid assets of \$125 million and deposit liabilities of \$500 million. What is the bank's liquidity ratio?

$$\begin{aligned}\text{Liquidity ratio} &= \text{liquid assets} / \text{deposit liabilities} \\ &= 125 / 500 = 25\%\end{aligned}$$

- If assets deposit liabilities grow to \$600 million, what level of liquid assets is needed in order to maintain the 25% liquidity ratio?

$$\begin{aligned}\text{Total assets} &= \text{deposit liabilities} * \text{liquidity ratio} \\ &= \$600 * 25\% = \$150 \text{ million}\end{aligned}$$

81

Liquidity Risk Monitoring and Control (cont'd)

Basel III:

Minimum liquidity requirements:

- **Liquidity Coverage Ratio (LCR)**
phase-in timing: 2015 = 60%; 2019 = 100%
- **Net stable funding ratio (NSFR)**
2018 minimum standard

82



Liquidity Risk Monitoring and Control (cont'd)

- **Liquidity Coverage Ratio (LCR)**

Identifies the amount of unencumbered, high quality liquid assets that can be converted into cash to meet a bank's net cash outflows for a 30-day stressed funding scenario specified by supervisors.

LCR = Stock of high quality liquid assets / Net cash outflows over a 30 day time period.

83



Liquidity Risk Monitoring and Control (cont'd)

High Quality Liquid Assets (HQLAs)

- Easily converted to cash at little or no loss of value
- Low credit and market risk
- Ease and certainty of valuation
- Low correlation with risky assets
- Listed on a developed and recognized exchange
- Active and sizeable market
- Presence of committed market makers
- Low market concentration
- Flight to quality

84

Liquidity Risk Monitoring and Control (cont'd)

• Net stable funding ratio (NSFR)

Establishes minimum acceptable amount of stable funding that must be in place based on the liquidity characteristics of a bank's assets and activities over 1 year horizon

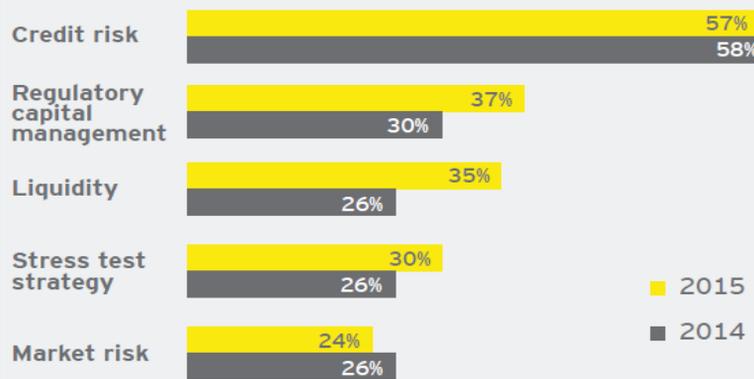
$$\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}}$$

Stable funding – types and amounts of equity and liability financing expected to be reliable sources of funds (for assets and off-balance sheet exposures) over a 1 year horizon under conditions of extended stress.

85

Banking Industry

Financial risk and balance sheet management remain top concerns for banks

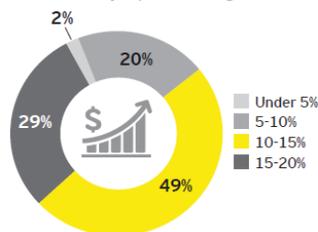


"Rethinking risk management: Banks focus on non-financial risks and accountability", EY's 2015 risk management survey of major financial institutions, is the sixth annual study of risk management practices conducted in cooperation with the Institute of International Finance (IIF). A total of 51 firms across 29 countries participated in this year's study.

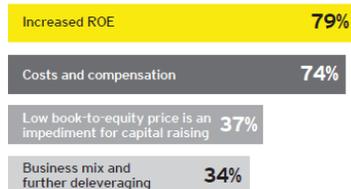
86

Banks and CFOs are under increasing pressure from investors to increase returns ...

Return on Equity (ROE) targets

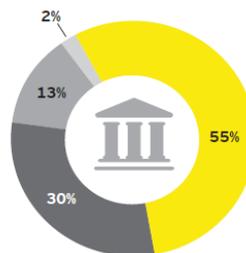
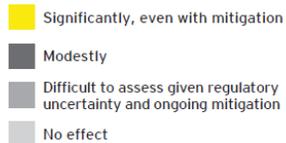


Top areas of investor focus



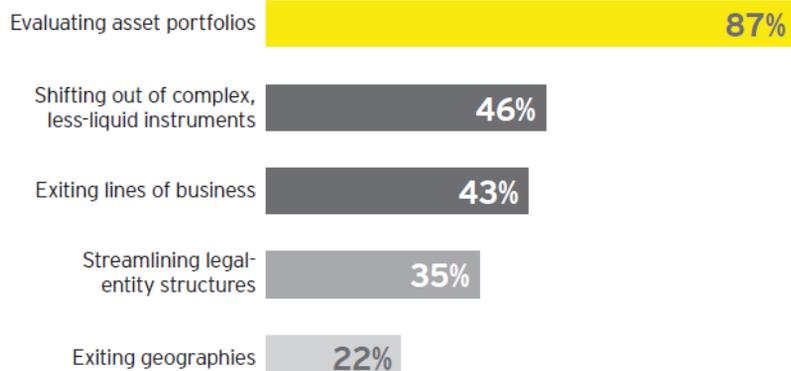
... as the costs of doing business rise

How much will costs rise due to combined liquidity and capital changes under Basel III?



87

The impact of higher capital and liquidity requirements on ROE is driving significant business model change



88

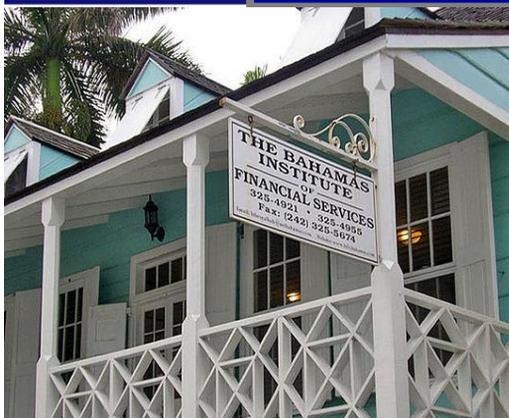


Sources

- **Basel Committee on Banking Supervision** – Principles for Sound Liquidity Risk Management and Supervision - <https://www.bis.org/bcbs/>
- **Central Bank of The Bahamas** – Guidelines for the Management of Liquidity Risk - <http://www.centralbankbahamas.com/>
- **EY and IIF - Rethinking risk management:** Banks focus on non-financial risks and accountability - <http://www.ey.com/gl/en/industries/financial-services/banking---capital-markets/ey-rethinking-risk-management>



Market Risk



The Commonwealth of The Bahamas

1

1



Market Risk (Module IV)

Jermaine J. Williams JP, CBMBA, BBA, CIRM, CCP
Bahamas Institute of Financial Services (BIFS)
Certified International Risk Management

June 2017



2

Course Agenda

- Defining Market Risk and the key components of Market Risk
- Basel II and IFRS overview on Market Risk
- Using VAR as a Risk Management tool and its limitations
- The importance of stress testing scenarios
- Setting market risk limits
- Reviewing market risk models

3

3

Market Risk and the Basel II Overview

- Market Risk
 - As defined by the Bank for International Settlements (“BIS”)
 - As defined by the International Financial Reporting Standards (“IFRS”)
- Basel II Overview
 - Basel II Market Risk Framework
 - Revisions to the Basel II Market Risk Framework

4

4

Definition of Market Risk – Basel II

- Market risk is defined as the risk of losses in on and off-balance-sheet positions arising from movements in market prices. The risks subject to this requirement are:
 - The risks pertaining to interest rate related instruments and equities in the trading book;
 - Foreign exchange risk and commodities risk throughout the bank.

Source: Basel Committee on Banking Supervision, Basel II: International convergence of capital measurement and capital standards: a revised framework, comprehensive version, June 2006, paragraph 683(i)

5

5

Definition of Market Risk - IFRS

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: **interest rate risk, currency risk, commodity risk** and **other price risk**.

Source: IFRS 7

6

6

Market Risk

How do you benchmark the quality of your ERM program in both normal and abnormal markets?

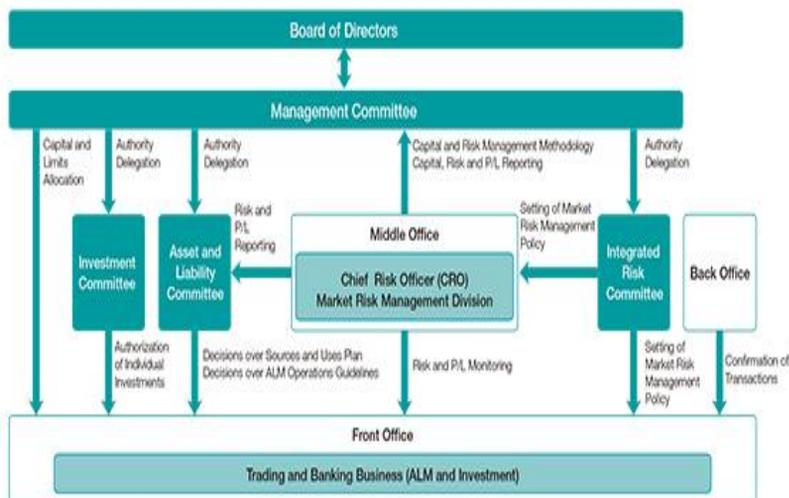
What is the value add of your ERM program from both an offensive and defensive point of view?



7

7

Market Risk Management System



8

8

Key Components of Market Risk

- Interest rate risk
- Currency risk
- Commodity price risk
- Other price risk



9

9

Definition of Currency Risk

Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Source: IFRS 7

10

10

Definition of Interest Rate Risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.



Source: IFRS 7

11

11

Types of Interest Rate Risk

- Shape of the yield curve
 - Normal
 - Flat
 - Inverse
- Yield curve shifts
 - Parallel
 - Nonparallel – twists
 - Nonparallel – butterfly shifts
- Measuring yield curve risk
 - Duration
 - Convexity

“A **yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.”

12

12

Shapes of the Yield Curve

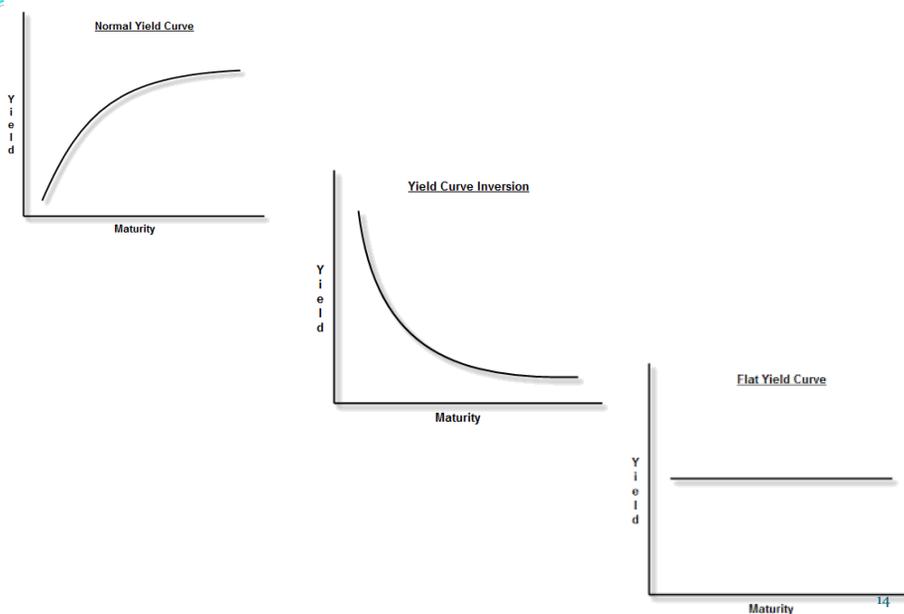
The shape of the yield curve gives an idea of future interest rate changes and economic activity.

- **Normal**
Normal or up-sloped yield curve indicates yields on longer-term bonds may continue to rise, responding to periods of economic expansion.
- **Inverse**
Inverse or down-sloped yield curve suggests yields on longer-term bonds may continue to fall, corresponding to periods of economic recession.
- **Flat**
May arise from normal or inverted yield curve, depending on changing economic conditions (e.g. economy is transitioning from expansion to slower development and even recession or economy is transitioning from recession to recovery and potentially expansion).

13

13

Shapes of the Yield Curve



14

Yield Curve Shifts

- **Parallel Shift**

Rates across the maturity spectrum change by a constant amount and the slope of the yield curve remains consistent.

- **Non-parallel Shift:**

Twist: The slope of the yield curve becomes flatter (the spread between short and long term yields narrows) or steeper (the spread between short and long term yields widens).

Butterfly: Change to the curvature of the yield curve.

Positive butterfly: The yield curve goes loses some of its “hump” and becomes straighter.

Negative butterfly: The yield curve takes on more of a hump and ceases to look similar to a straight line.

15

15

Measuring yield curve risk

Yield curve risk refers to the probability that the yield curve will shift in a manner that affects the values of securities tied to interest rates -- particularly, bonds.

- **Duration**

It is a measurement of how long, in years, it takes for the price of a bond to be repaid by its internal cash flows. It is an important measure for investors to consider, as bonds with higher durations carry more risk and have higher price volatility than bonds with lower durations.

For each of the two basic types of bonds the duration is the following:

Zero-Coupon Bond – Duration is equal to its time to maturity.

Vanilla Bond - Duration will always be less than its time to maturity.

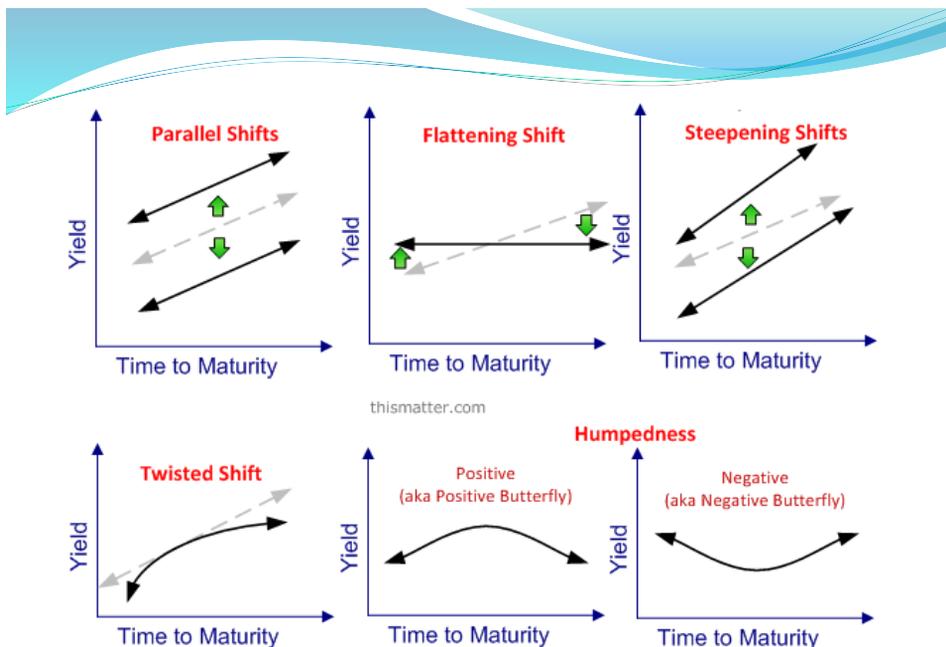
- **Convexity**

For any given bond, a graph of the relationship between price and yield is convex. This means that the graph forms a curve rather than a straight-line (linear). The degree to which the graph is curved shows how much a bond's yield changes in response to a change in price.

“Hedging interest rate risk can be done using interest rate future, interest rate options, interest rate swaps”

16

16



17

17

Interest rate risk:

Central Bank of the Bahamas: Monetary Policy in The Bahamas

- In an effort to position the domestic business sector to take more advantage of growth opportunities in the near-term, and to provide more support to housing sector investments, the Central Bank reduced the Discount Rate by 50 basis points to 4.00 percent, effective December 22nd, 2016. The Bank requested that financial institutions follow suit with a corresponding reduction in the Prime Rate, from 4.75 percent to 4.25 percent, and similar adjustments in their lending rate schedules. Commercial banks announced the reduction in the Prime Rate to 4.25%, effective January 5th, 2017.

18

18

Examples of Currency Risk

- The risk of receiving less in the domestic currency when invested in a bond issue that makes payments in a foreign currency. This risk applies to coupon payments and the principal payment at maturity.
- **Transaction Risk** - the risk of receiving less or paying more in domestic currency when entering into a business contract to receive payment or take delivery in a foreign currency at a specified date in the future.

Hedging of these risks can be done using currency forward contracts or currency futures contracts.

19

19

Definition of Commodity Risk

Commodity risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in commodity prices.

Source: IFRS 7

20

20

Examples of Commodity Risk

- The risk of receiving less or paying more in domestic currency when entering into a business contract to receive payment for the sale of a commodity or take delivery of a commodity in a foreign currency at a specified date in the future.

Hedging of these risks can be done using primarily futures contracts

21

21

Definition of Other Price Risk

Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk, currency risk, or commodity risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

Source: IFRS 7

22

22

Four tools to manage commodity risk and volatility



Source: A.T. Kearney analysis

23

23

Basel II Overview

The history of papers that preceded the latest version of the Basel II market risk framework are:

- The Basel Capital Accord of July 1988.
- Basel Committee on Banking Supervision, Modification of the Basel Capital accord of July 1988, as amended in January 1996, press release, 19 September 1997 (Basel I).
- Basel Committee on Banking Supervision, Basel II: International convergence of capital measurement and capital standards: a revised framework, comprehensive version, June 2006.
- Basel Committee on Banking Supervision, Proposed revisions to the Basel II market risk framework, consultative document, July 2008.
- Basel Committee on Banking Supervision, Proposed revisions to the Basel II market risk framework, consultative document, January 2009.
- Basel Committee on Banking Supervision: Revisions to the Basel II market risk framework, July 2009.

24

24

BASEL II + MARKET RISK AMENDMENT

Pillar I – Min Capital Requir'ts	Pillar II – Supervisory Review	Pillar III – Market Discipline
<p>Credit Risk:</p> <ul style="list-style-type: none"> - Standardized Approach - Foundation IRB Approach - Advanced IRB Approach <p>Market Risk</p> <ul style="list-style-type: none"> - Standardized Approach - Internal VAR Models <p>Operational Risk</p> <ul style="list-style-type: none"> - Basic Indicator Approach - (Alt) Standardized Approach - Advanced Measurement Approach 	<p>Regulatory Framework for banks</p> <ul style="list-style-type: none"> - Internal Capital Adequacy Assessment Process (ICAAP) - Risk Management <p>Supervisory Framework</p> <ul style="list-style-type: none"> - Evaluation of internal systems of banks - Assessment of risk profile - Review of compliance with regulations - Supervisory measures 	<p>Disclosure requirements:</p> <ul style="list-style-type: none"> - Transparency for market participants concerning the bank's risk position (scope of application, risk management, detailed information on own funds, etc) - Enhanced comparability of banks

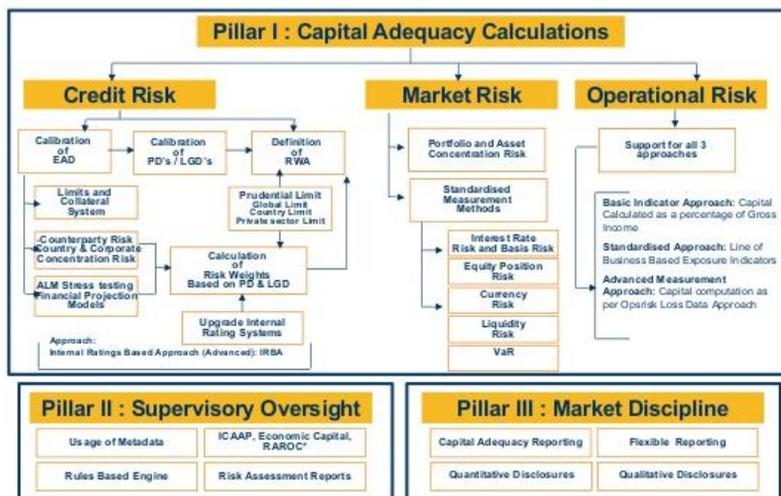
Tier 2 no more than 100% of Tier 1
Tier 3 for Market Risk only (T3 is eliminated in Basel III)

$$\frac{\text{RWA}_{\text{Credit}} + [\text{MRC}_{\text{Market}} \times 12.5] + [\text{ORC}_{\text{Opri}} \times 12.5]}{\text{Total Regulatory capital: Tier-1,2,3}} \geq 8\%$$

25

25

Basel II 3 Pillar Analytics



* Risk-Adjusted Return on Capital (RAROC)

26

26



Basel I Shortcomings

- Capital required did not mirror a bank's true risk profile
- Too simple for advanced banks
- Inflexible against new developments
- Covers only credit and market risks
- Only quantitative in nature
- Limited recognition of collateral

Source: Financial Crisis and the Implementation of Basel II: Potential Economic Impact for Trinidad and Tobago, by *Lester Henry and Michelle Majid*

27

27



Basel II Objectives

- Greater emphasis on banks' own assessment of risk
- Comprehensive framework for credit, market and operational risk
- Encourages rigorous bank supervision
- Ensures market transparency, disclosure
- More risk sensitive; better align regulatory capital with actual risk exposure

Source: Financial Crisis and the Implementation of Basel II: Potential Economic Impact for Trinidad and Tobago, by *Lester Henry and Michelle Majid*

28

28



Minimum capital requirements for market risk

The 2007-08 period of severe market stress exposed weaknesses in the framework for capitalizing risks from trading activities.

In 2009, the Committee introduced a set of revisions to the Basel II market risk framework to address the most pressing deficiencies.

A fundamental review of the trading book was also initiated to tackle a number of structural flaws in the framework that were not addressed by those revisions. This has led to the revised market risk framework, which is a key component of the Basel Committee's reform of global regulatory standards in response to the global financial crisis.

29

29



Minimum capital requirements for market risk

The purpose of the revised market risk framework is to ensure that the standardized and internal model approaches to market risk deliver credible capital outcomes and promote consistent implementation of the standards across jurisdictions.

The final standard incorporates changes that have been made following two consultative documents published in October 2013 and December 2014 and several quantitative impact studies.

30

30

Minimum capital requirements for market risk

The key features of the revised framework include:

- *A revised boundary between the trading book and banking book*
- *A revised internal models approach for market risk*
- *A revised standardized approach for market risk*
- *A shift from value-at-risk to an expected shortfall measure of risk under stress*
- *Incorporation of the risk of market illiquidity*

The revised market risk framework comes into effect on **1 January 2019**.

31

31

IFRS Overview of Market Risk

International Financial Reporting Standards ("IFRS"), IFRS 7

Sensitivity analysis

Paragraph 40

Unless an entity complies with paragraph 41, it shall disclose:

- a sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at the date;
- the methods and assumptions used in the preparing the sensitivity analysis; and
- changes from the previous period in the methods and assumptions used, and the reasons for such changes.

32

32

IFRS Overview of Market Risk

International Financial Reporting Standards ("IFRS"), IFRS 7

Sensitivity analysis...cont

Paragraph 41

- If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependence between risk variables (e.g. interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in paragraph 40. The entity shall also disclose:
 - an explanation of the method used in preparing such a sensitivity analysis and of the main parameters and assumptions underlying the data provided; and
- an explanation of the objective of the method used and of limitation that may result in the information not fully reflecting the fair value of the assets and liabilities involved

33

33

IFRS Overview of Market Risk

International Financial Reporting Standards ("IFRS"), IFRS 7

Paragraph 42

- When the sensitivity analysis disclosed in accordance with paragraph 40 or 41 are unrepresentative of a risk inherent in a financial instrument (for example because the year-end exposure does not reflect the exposure during the year), the entity shall disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

34

34

IFRS Overview of Market Risk

International Financial Reporting Standards ("IFRS"), IFRS 7

IG32 - Paragraph 40(a) requires a sensitivity analysis for each type of market risk to which the entity is exposed. There are three types of market risk: interest rate risk, currency risk and other price risk. Other price risk may include risk such as equity price risk, commodity price risk, prepayment risk (i.e. the risk that one party to a financial asset will incur a financial loss because the other party repays earlier or later than expected), and residual value risk (e.g. a lesser of motor cars that writes residual value guarantees is exposed to residual value risk). Risk variables that are relevant to disclosing markets risk include, but are not limited to:

- the yield curve of market interest rates. It may be necessary to consider both parallel and non-parallel shifts in the yield curve.
- foreign exchange rates;
- prices of equity instruments; and
- market prices of commodities.

35

35

IFRS Overview of Market Risk

International Financial Reporting Standards ("IFRS"), IFRS 7

IG33 - Paragraph 40(a) requires the sensitivity analysis to show the effect on profit or loss and equity of reasonably possible changes in the relevant risk variable. For example, relevant risk variables might include:

- prevailing market interest rates, for interest-sensitive financial instruments such as a variable-rate loan; or
- currency rates and interest rates, for foreign currency financial instruments such as foreign currency bonds.

36

36



IFRS Overview of Market Risk

International Financial Reporting Standards ("IFRS"), IFRS 7

IG34 - For interest rate risk, the sensitivity analysis might show separately the effect of a change in market interest rates on:

- interest income and expense;
- other line items of profit or loss (such as trading gains and losses); and
- when applicable, equity.

An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk.

37

37



IFRS Overview of Market Risk

International Financial Reporting Standards ("IFRS"), IFRS 7

- IG35 - Because the factors affected market risk vary depending on the specific circumstances of each entity, the appropriate range to be considered in providing a sensitivity analysis of market risk varies for each entity and for each type of market risk.
- IG36 - includes disclosure examples regarding interest rate risk and foreign currency risk.

38

38

IFRS Overview of Market Risk

International Financial Reporting Standards ("IFRS"), IFRS 7

Other market risk disclosures (paragraph 42)

IG 37 - Paragraph 42 requires the disclosure of additional information when the sensitivity analysis disclosed is unrepresentative of a risk inherent in a financial instrument. For example, this can occur when:

- a financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis, e.g. options that remain out of (or in) the money for the chosen change in the risk variable;
- financial assets are illiquid, e.g. when there is a low volume of transactions in similar assets and an entity finds it difficult to find a counterparty; or
- an entity with a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding.

39

39

IFRS Overview of Market Risk

International Financial Reporting Standards ("IFRS"), IFRS 7

IG38 - In the situation of paragraph IG37(a), additional disclosure might include:

- the terms and conditions of the financial instruments (e.g. the options);
- the effect on profit or loss if the term or condition were met (i.e. if the options were exercised); and
- a description of how the risk is hedged.

For example, an entity may acquire a zero-cost interest rate collar that includes an out-of-the-money leveraged written option (e.g. the entity pays ten times the amount of the difference between a specified interest rate collar as an inexpensive economic hedge against a reasonably possible increase in interest rates. However, an unexpectedly large decrease in interest rates might trigger payments under the written option that, because of the leverage, might be significantly larger than the benefit of lower interest rates. Neither the fair value of the collar nor a sensitivity analysis based on reasonably possible changes in market variables would indicate this exposure. In this case, the entity might provide the additional information described above.

40

40

IFRS Overview of Market Risk

International Financial Reporting Standards (“IFRS”), IFRS 7

IG39 - In the situation described in paragraph IG37(b), additional disclosure might include the reasons for the lack of liquidity and how the entity hedges the risk.

IG40 - In the situation described in paragraph IG37©, additional disclosure might include:

- the nature of the security (e.g. entity name);
- the extent of holding (e.g. 15 per cent of the issued shares);
- the effect on profit or loss; and
- how the entity hedges the risk.

41

41

Value at Risk (“VaR”)

- **Methodologies:**

- **Variance Covariance** – multiplies market value exposure by the standard deviation of price changes
- **Historical Data** – run the portfolio through actual historical data and computing the change that would have occurred
- **Monte Carlo** – this is a simulation program that running multiple simulations based on probability distributions for each of the market risk factors

42

42

VaR

- **Variance Covariance – Pros**
 - Fast
 - Relatively easy to implement
 - Consistent measurement tool
 - Data sets are readily available (RiskMetrics)
 - Defines what is low and high risk
 - Requires only portfolio level sensitivities
 - Constant reference point for staff

43

43

VaR

- **Variance Covariance – Cons**
 - Assumes normal distributions or distributions similar to normal which may understate the true VaR
 - Does not capture “Fat Tails”
 - Input error – the variance-covariance matrix is a collection of estimates, so of which have very large error terms
 - Non-stationary variables – occurs when the variances and covariances across assets change over time
 - Difficult to estimate market liquidity
 - Does not revalue positions
 - Multiple time horizons cannot be incorporated
 - Complex or discontinuous payoffs cannot be accounted for
 - Loss estimates based on the selected confidence interval

44

44



VaR

- Historical Simulations - Pros
 - Requires no assumption about distributions
 - Relies on volatility and correlation embedded in selected time series
 - Captures fat tails (extreme events) in price change distribution, which are not captured in a normal distribution
 - Relatively easy to compute
 - Can capture non-linear risks

45

45



VaR

- Historical Simulations - Cons
 - Relies on historical data – the past is not necessarily a good predictor of the future
 - Trends in time series data – if volatility is increasing over time, the VaR estimate will understate true VaR
 - Data intensive – requires numerous time series
 - New assets or market risks – VaR cannot necessarily be estimated

46

46



VaR

- Monte Carlo Simulation - Pros
 - Accommodates a variety of statistical models and assumptions
 - Produces a distribution of profit & loss changes
 - Unrealistic assumptions about normality are not required
 - Flexible enough to run VaR for any type of portfolio and are flexible enough to handle options and option-like securities
 - Provides greatest level of control over price volatility
 - Can capture non-linear risks

47

47



VaR

- Monte Carlo Simulation - Cons
 - Mathematically intensive – can require tens of thousands of simulations
 - Requires distribution and correlation assumptions
 - Less transparent
 - Does not capture “Fat Tails”

48

48



Comparing Approaches

- Variance-covariance requires strong assumptions about the return distributions of standardized assets, but is easy to compute once these assumptions have been made.
- The historical simulation requires no assumptions about return distributions, but implicitly assumes that the data used in the simulation is representative of risks going forward.
- The Monte Carlo simulation approach allows for more flexibility when choosing distributions and bringing in subjective judgments and external data, but it is the most demanding from a computational standpoint.

49

49



Confidence Intervals

- 90% confidence interval = 1.65 standard deviations
- 95% confidence interval = 1.96 standard deviations
- 99% confidence interval = 2.33 standard deviations

50

50

Variance Covariance



51

51

Sensitivity Approach - Inputs

Security Exposure	Unit of Measure
Interest rate exposure	Dollar value per basis point change in rate
Foreign exchange Equity Commodity	Dollar value of the position
Options	Dollar value adjusted for option delta plus gamma expressed as a change in delta

52

52

Sensitivity Aggregation

Security - Bonds	Sensitivity
\$1 million 5 Year USD T-bond	\$200/basis point
\$1 million 10 Year USD T-bond	\$450/basis point
\$1 million 15 Year USD T-bond	\$800/basis point
Total for Bond Portfolio	\$1,450/basis point

Fortunately the sensitivities can be aggregated to arrive at the USD bond portfolio sensitivity to change in interest rates.

53

53

VaR Example for a Single Asset

Asset	Exposure	One Day Volatility	Risk
2,000 shares of GE at \$25/share	$2,000 * \$25 = \$50,000$	1.5%	$\$50,000 * 1.5\% = \750

54

54

VaR Example for a Two Asset Portfolio

Asset	Exposure	One Day Volatility	Risk
10,000 shares of GE at \$25/share	$10,000 * \$25 = \$250,000$	1.5%	$\$250,000 * 1.5\% = \$3,750$
\$20 million 15 Yr US T-Bond	$\$800/\text{bp} * 20 = \$16,000/\text{bp}$	2 bps	$\$16,000/\text{bp} * 2 \text{ bps} = \$32,000$
Assume the correlation between the assets is 0.3			
Two Asset Portfolio Risk (VaR)			\$33,317.60

If we simply add the risk for each asset the total risk is \$35,750, the correct total is \$33,317.60 or \$2,182.40 less. This is due to the diversification benefit given that the correlation between the assets is only 0.3. If the correlation was 1.0, then there would not be a diversification benefit.

55

55

VaR Example for a Three Asset Portfolio

Asset	Exposure	One Day Volatility	Risk
10,000 shares of GE at \$25/share	$10,000 * \$25 = \$250,000$	1.5%	$\$250,000 * 1.5\% = \$3,750$
\$20 million 15 Yr US T-Bond	$\$800/\text{bp} * 20 = \$16,000/\text{bp}$	2 bps	$\$16,000/\text{bp} * 2 \text{ bps} = \$32,000$
1,000 ounces of Gold at \$1,400/ounce	$1,000 * \$1,400 = \$1,400,000$	3.0%	$\$1,400,000 * 3.0\% = \$42,000$
Assume the correlation between the assets 1 & 2 is 0.3 Assume the correlation between assets 1 & 3 is 0.2 Assume the correlation between assets 2 & 3 is 0.1			
Two Asset Portfolio Risk (VaR)			\$56,620.34

If we simply add the risk for each asset the total risk is \$77,750, but the correct total is \$56,620.34 or \$21,129.66 less. This is due to the diversification benefit given that the correlation between the assets is only 0.3, 0.2, and 0.1.

56

56

Adjusting the VaR Estimation Period

- Adjusting VaR from one estimation period to another is simpler than one may expect.
- If the period is lengthened you multiply the VaR by the square root ("sqrt") of the increase in trading days.
- If the period is shortened you divide the VaR by the square root of the increase in trading days.
- Assuming a one day VaR of \$10,000

Period Adjustment	Trading days	Adjustment	VaR
1 week	5	sqrt(5)	22,360.68
1 month	21	sqrt(21)	45,825.76
3 months	62.5	sqrt(62.5)	79,056.94
1 year	250	sqrt(250)	158,113.90

57

57

VaR Confidence Intervals

- Confidence intervals are based on what is called in statistics, the Z-Value.
- The table below details the # of standard deviations (σ 's) required for a given confidence interval.

Z-Value	
Confidence	# of σ 's
84%	1.00
90%	1.28
95%	1.65
97.5%	1.96
99%	2.33

58

58

Sources

- Basel Committee on Banking Supervision, Basel II: International convergence of capital measurement and capital standards: a revised framework, comprehensive version, June 2006
- Basel Committee on Banking Supervision: Revisions to the Basel II market risk framework
- Basel Committee on Banking Supervision: Minimum capital requirements for market risk
- International Financial Reporting Standards (“IFRS”), IFRS 7
- Financial Crisis and the Implementation of Basel II: Potential Economic Impact for Trinidad and Tobago, by *Lester Henry and Michelle Majid*
- Francesco Cannata Mario Quagliariello (2009)
- Van Kemper, Cris (2009)
- www.investopedia.com
- www.financetrain.com

59

CERTIFIED INTERNATIONAL RISK MANAGER

MODULE V
Regulation and Compliance Risks
Lecturer
Samuel J. Wilkinson

Module V
All Rights Reserved

1



2

Risk Management Process

Business Risk

Depending upon an individual business' size, activities, clientele and geographical location, it may experience the following risks during its lifetime:

3

Risk Management Process

- ▣ Legal Risk-Financial/reputational loss for non-compliance.
- ▣ Regulatory Risk-Material impact of change in laws.
- ▣ Reputation Risk-Threat to entity's good name.
- ▣ Technology Risk-Disruption by technology failures.
- ▣ Compliance Risk-Loss for non-compliance with laws.
- ▣ Credit risk-Risk of default on debt.
- ▣ Market risk-Losses due to market changes.
- ▣ Fiduciary risk-Agent failing to act in client's interest.
- ▣ Operational Risk-Loss from failed procedures.

4

Key Risks

- Four key risk areas within an organization:
 - 1. Strategic Risks- Risk of failed organizational long-term objectives.
 - 2. Operational Risks- Major risks that affect the organization's ability to execute the strategic plan.

5

Key Risks

- Financial Risks-Financial reporting, valuation, market, liquidity and credit risks.
- Compliance Risks – Risks related to legal and regulatory compliance.

6

Risk Management Process

- ▣ Each risk has its own definition and impact on a business.
- ▣ Each risk requires careful identification, analysis, monitoring and control.
- ▣ The key stakeholders must be identified and the relevant committees established (e.g. risk management committee and credit committee), to address these risks.

7

Risk Management Process

The Four Stages in the Risk Management Process:

- **Risk Identification and Assessment**
Identify the money laundering and associated legal, regulatory and reputational risks facing the firm, given its customer, product, and service profile and having regard to available information, including published typologies.

8

Risk Management Process

- **Risk Mitigation**

Identifying and applying measures to mitigate the material risks emerging from the assessment.

- **Risk Monitoring**

Implement management information systems (MIS) to keep up to date with changes to the company's risk profile and threats facing the entity.

9

Risk Management Process

Document – Document - Document

- Implement policies and procedures that cover the risk management process, and which require effective accountability from the board, senior management and other staff.

10



11

Corporate Governance – Risk, Compliance & Ethics

- ❖ Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the best interest of the company.
- ❖ This includes shareholders who should monitor the board to ensure that it carries out its fiduciary responsibility to act in good faith.

12

Corporate Governance

- Corporate governance provides the foundation and critical underpinning for the relationships, responsibilities, and reporting lines for the board of directors, senior management, shareholders, employees, clients and other stakeholders of an organization.

13

Corporate Governance

- The following stakeholders are the beneficiaries of an effective corporate governance regime:
 - Shareholders
 - Employees
 - Investors
 - Service providers/suppliers
 - The community
 - Government

14

Corporate Governance

- At the center of the requirement for good corporate governance is the proper understanding, appreciation and practice of the high standard of duty, skill and care expected of directors and senior management.
- The prudent discharge of their duties and responsibilities, both internally and externally, within the ambit of applicable law, local regulations, and international standards of best practice are crucial to every company's success and reputation.

15

Corporate Governance

The Process

A comprehensive understanding of their responsibilities and accountabilities by directors and senior management, and clear, consistent communication of the process of good corporate governance within an organization to stakeholders, are paramount to the effectiveness of any corporate governance regime.

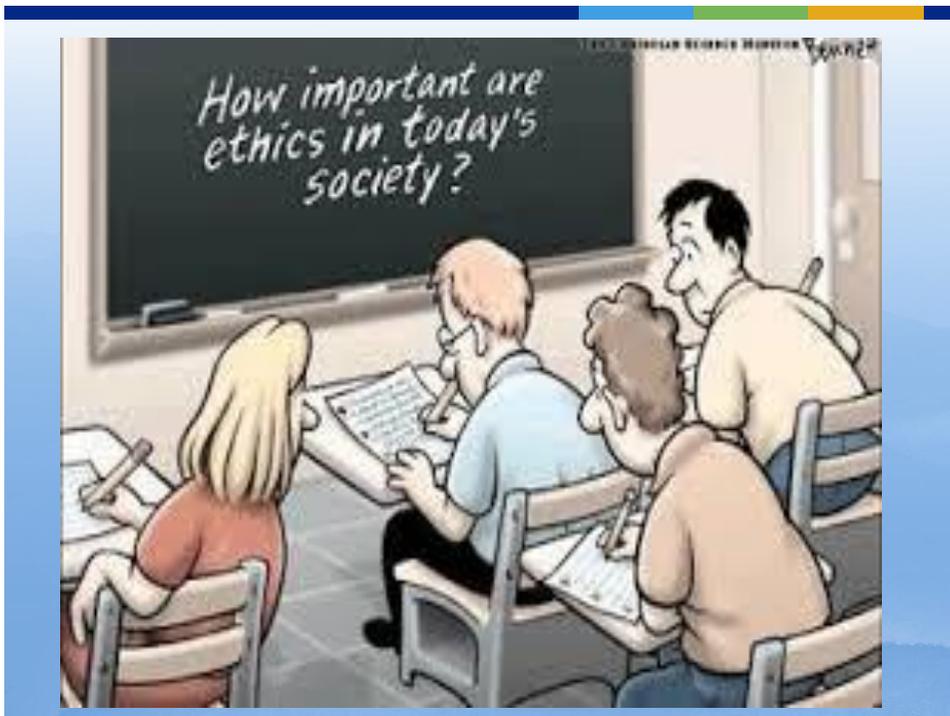
16

Corporate Governance

▣ The Process Con't...

Measurable criteria such as the accuracy, reliability, timeliness, relevancy, and thoroughness of an organization's risk management system and the frequency with which directors and senior management are able to obtain information regarding these measurements are critical to the soundness of any corporate governance programme and its attendant compliance requirements.

17



18

Ethics – Truth or Dare?

- ▣ Ethics is a body of principles or standards of human conduct that govern the behaviour of individuals and groups. Ethics is essentially about how people behave.
- ▣ Business ethics is about how people behave in relationships with each other in a business/commercial setting. These people include shareholders, managers, staff, clients, and the general public.
- ▣ Although we cannot force people to be ethical, we can help people understand their ethical, legal, and practical roles, duties, and responsibilities in the industry in which they work.
- ▣ We can also help people to understand what factors to consider in deciding the best possible outcome.

19

Fundamentals of Regulation

Principles vs. Rules - Based Regulation

20

Regulation? What's the Motivation?



"These new regulations will fundamentally change the way we get around them."

Module V - Samuel J Wilkinson - All Rights Reserved

21

Important Terms

- **Regulations:** 1) Bring into conformity rules or principles. 2) They determine, shape, influence and give direction to a process. 3) Rules that are made and maintained by an authority e.g. CBOB, FCA, BSA.
- **Paradox:** An argument that produces an inconsistency, typically within logic or common sense; A statement that is seemingly contradictory or opposed to common sense and yet is perhaps true; A self-contradictory statement that at first seems true; Situation or action having seemingly contradictory qualities or phases.

Module V - Samuel J Wilkinson - All Rights Reserved

22

Principles-Based Regulation

- Movement away from reliance on detailed, prescriptive rules.
- Greater reliance on more high-level, broadly stated rules or principles to set the standards by which regulated firms must conduct business.
- Outcomes-based regulation.
- Increased senior management responsibility.

Module V - Samuel J Wilkinson - All Rights Reserved

23

Principles-Based Regulation

- A broad set of standards that gesture in the direction of certain desired outcomes.
- These standards may be accompanied by guidelines about how to achieve the outcomes.

Module V - Samuel J Wilkinson - All Rights Reserved

24

Rules-Based Regulation

- At the regulatory level, a rules-based approach relies on detailed, prescriptive rules and regulations.
- No tolerance for broad-based, “vague” standards.

Module V - Samuel J Wilkinson - All Rights Reserved

25

Rules-Based Regulation

- Rules based on a set of detailed requirements that govern a firm’s behavior.
- Rules enable firms to “tick-the-box” to guarantee compliance with law.

Module V - Samuel J Wilkinson - All Rights Reserved

26

What Is The Reality?

- Common law legal regimes are comprised of both principles and rules.
- Civil law is rules-based and guided by codified and statutory law

Module V - Samuel J Wilkinson - All Rights Reserved

27

The Rules-Based Approach

Sarbanes-Oxley Act (US)

- Rules-based structure: Perceived by many as hopelessly “complex”, “murky”, and “harder to understand and harder to follow” than more flexible regimes in other nations.
- *HOWEVER*, according to the U.S. Treasury, the SOA rules-based regulation has served the United States very well and is part of the foundation for its prosperity and growth.

Module V - Samuel J Wilkinson - All Rights Reserved

28

The Principles-Based Approach

- ❑ What principles-based regulation does mean and should mean, is moving away from prescriptive rules to a higher level of articulation.
- ❑ It emphasises that what really matters is not that any particular box has been ticked but rather that when making decisions, executives know they will be judged on the consequences – the results of those actions.

Module V - Samuel J Wilkinson - All Rights Reserved

29

The Difference Between Rules and Principles – An Example

- A rule will say: “Do not drive faster than 90 m/h”
- A principle will say: “Do not drive faster than is reasonable and prudent in all the circumstances”

Module V - Samuel J Wilkinson - All Rights Reserved

30

Business Principles That Mitigate Regulatory & Compliance Risks

- ❖ A firm must conduct its business with integrity.
- ❖ A firm must conduct its business with due skill, care and diligence.
- ❖ A firm must take reasonable care to organize and control its affairs responsibly and effectively with adequate risk management systems.

Module V - Samuel J Wilkinson - All Rights Reserved

31

Business Principles That Mitigate Regulatory & Compliance Risks

- ❖ A firm must maintain adequate financial resources.
- ❖ A firm must observe proper standards of market conduct.
- ❖ A firm must pay due regard to the interest of its customers and treat them fairly.
- ❖ A firm must communicate information to clients in a way that is clear, fair and not misleading.

Module V - Samuel J Wilkinson - All Rights Reserved

32

Business Principles That Mitigate Regulatory & Compliance Risks

- ❖ A firm must manage conflicts of interest fairly.
- ❖ A firm must take reasonable care to ensure the suitability of its advice for any customer who is entitled to rely on its judgment.
- ❖ A firm must arrange adequate protection for its client's assets when it is responsible for them.
- ❖ A firm must deal with its regulators in an open and cooperative way by providing full disclosure where appropriate.

Module V - Samuel J Wilkinson - All Rights Reserved

33

The Rules-Based Approach

Advantages

- Greater clarity and certainty.
- Greater transparency.
- More operational than principles.

Module V - Samuel J Wilkinson - All Rights Reserved

34

The Rules-Based Approach

Disadvantages

- High compliance costs.
- Initiative and innovation depressed.
- Excessive litigation.
- Capital markets less attractive to investors.



Module V - Samuel J Wilkinson - All Rights Reserved

35

The Principles-Based Approach

Advantages:

- Flexible and greater freedom for decision making.
- More productive dialogue between supervisor and supervised.
- Capacity for growth and development.
- Robust or ability to cope with change.

Module V - Samuel J Wilkinson - All Rights Reserved

36

The Principles-Based Approach

Disadvantages:

- Uncertainty
- Unpredictability
- Supervision and enforcement more challenging



Module V - Samuel J Wilkinson - All Rights Reserved

37

Seven (7) Paradoxes of Principles-Based Legislation

- 1. THE INTERPRETIVE PARADOX:**
Principles can be general yet precise.
- 2. THE COMMUNICATIVE PARADOX:**
Principles can facilitate communication but can also hinder it.
- 3. THE COMPLIANCE PARADOX:**
Principles provide scope for flexibility in compliance yet can lead to conservative and/or uniform behaviour by regulated firms.
- 4. THE SUPERVISORY AND ENFORCEMENT PARADOX:**
Principles need enforcement to give them credibility but over-enforcement can lead to their demise.

Source: "Seven Paradoxes of Principles Based Regulation" by Julia Black
 Module V - Samuel J Wilkinson - All Rights Reserved
 LSE Law, Society and Economy Working Papers 13/2008

38

Seven (7) Paradoxes of Principles-Based Legislation

5. THE INTERNAL MANAGEMENT PARADOX:

PBR can provide flexibility for internal control systems to develop but can overload them.

6. THE ETHICAL PARADOX:

PBR can facilitate a more ethical approach but it could result in an erosion of ethics.

7. THE TRUST PARADOX:

PBR can give rise to relationships of trust, mutuality and responsibility but these are the very relationships which have to exist for it to be effective.

Source:
 "Forms and Paradoxes of Principles Based Regulation" by Julia Black
 LSE Law, Society and Economy Working Papers 13/2008

Module V - Samuel J Wilkinson - All
 Rights Reserved

39

Conflicts of Interest in the Financial Industry

MANAGING CONFLICT OF INTEREST



40

What Are Conflicts of Interest?

- A type of moral hazard that occurs when a person or institution has multiple objectives (interests) that result in conflicts between them.
- It usually take the form of misleading information.
- Financial institutions can profit from giving out misleading information to the public.
- Leads to unethical behavior.
- Occur when an institution or employee serves his interests at the expense of others.

41

Conflict of Interest

- A director may become legally liable if his conflict of interest breaches his duty of loyalty or affects his duty to act in good faith in the best interest of the company.

42



43

Types of Conflict of Interests

- ▣ Self dealing
- ▣ Outside Employment which contradicts/competes with existing employment
- ▣ Hiring family, friends, or business associates for contractual work, without authorization or consent
- ▣ Receiving gifts from potential investors, clients, or service providers without authorization and making decisions regarding those persons' involvement or relationship with the company

44

Problems That Result From Conflicts of Interest

- ❑ Conflicts of interest become a problem for the financial system when they lead to a decrease in the flow of reliable information.
- ❑ The decline in the flow of reliable information can slow the flow of credit to parties with productive investment opportunities.

45

Problems That Result From Conflicts of Interest

- ❑ Threats to truthful reporting in an audit arise from several potential conflicts of interest.
- ❑ Conflict occurs when an accounting firm provides its client with auditing services and non-audit consulting services called management advisory services. Examples include tax services, accounting and management information systems.

46

Sources of Conflict For Accounting Firms

- ▣ Accounting firms that provide multiple services earn greater profits but have three potential sources of conflicts of interest:
 1. Clients may pressure auditors into skewing their judgments and opinions by threatening to take their accounting and management services business to another accounting firm.
 2. If auditors are analyzing information systems or examining tax and financial advice put in place by their non-audit counterparts within the accounting firm, they may be reluctant to criticize the advice or systems.

47

Sources of Conflict For Accounting Firms

- ▣ Both types of conflicts might potentially lead to biased audits.
- ▣ With less reliable information available to investors, it becomes more difficult for financial markets to allocate capital efficiently.
- 3. The auditor provides an overly favorable audit in an effort to solicit or retain audit business.
 - ▣ The unfortunate collapse of Arthur Andersen suggest this may be the most dangerous conflict of interest for an accounting firm.

48

Underwriting Problems in Investment Banking

- Analysts in investment banks are sometimes persuaded to distort their research to please the underwriting department of their bank and the corporations issuing the securities.
- This undermines the reliability of information investors use for financial decisions and diminishes the efficiency of securities markets.

49

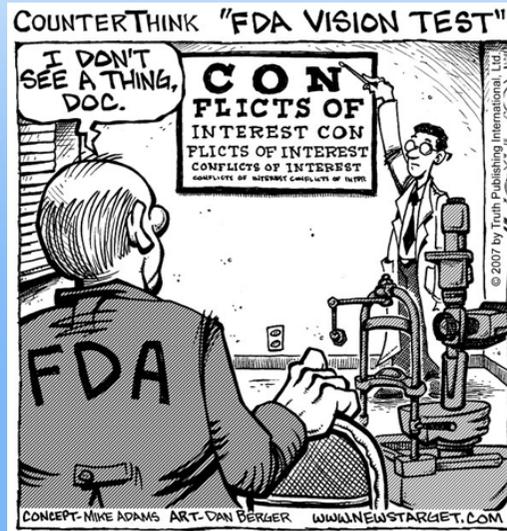
Problems Caused by Spinning

- Spinning occurs when investment banks allocate underpriced shares of newly issued stock to executives of other companies in order to 'persuade' them to use that investment bank
- When the executives' company plans to issue its own securities it uses that investment bank as an underwriter.
- This causes a rise in the cost of capital for the firm and hinders the efficiency of the capital market.

50

Examples of Conflicts of Interest

- Standard & Poor's
- Fitch Ratings
- Moody's Corp.
- Goldman Sachs



51

Rating Agencies Conflict of Interest

- Rating agencies are paid for their services by the entity that is seeking a credit rating for itself or for one of its debt issues.
- Agencies may give high paying clients a higher more favorable rating.
- Result? Consumers buy bonds and other debt instruments with AAA ratings only to end up losing.
- Fitch Ratings and Standard & Poor's rated CDO's (Collateralized Debt Obligations) issued by Credit Suisse as AAA. Losses on \$340 million worth of CDO's amounted to \$125 million!!

52

Goldman Sachs Group Inc.

- Goldman Sachs Group Inc. was investigated by the Securities & Exchange Commission (SEC) for fraud in a mortgage securities transaction.
- What was the conflict of interest in this transaction?

53

Goldman Sachs Group Inc.

- Goldman Sachs purchased many mortgages from the US housing market.
- They converted them into mortgage backed securities.
- They advised clients to buy these mortgages.
- At the same time they sold these mortgage securities short as either a hedge against their portfolio to reduce risk or as a major position anticipating a drop in value in the US housing market.

54

Goldman Sachs Group Inc.

- ❑ Goldman Sachs did not disclose (as required) to the clients purchasing these mortgage products that they were also shorting these same securities.
- ❑ Result? Goldman Sachs was acting in their own best interest as opposed to that of their clients.

This is a conflict of interest!

55

Penalties If Found Guilty

Goldman Sachs, a premier investment banking firm may be:

- Heavily fined.
- Broken up.
- Lose their clients trust, which is Goldman Sachs Group Inc. most valuable asset.

56

What Has Been Done to Remedy Conflicts of Interest?

- ❖ Sarbanes-Oxley Act of 2002
- ❖ Global Legal Settlement of 2002 (Agreement between SEC and Investment Banks)

57

Sarbanes-Oxley Act (SOX) of 2002

Four Major Components of SOX

1. **Supervisory oversight to monitor and prevent conflicts of interest**
 - Establishment of Public Company Accounting Oversight Board (PCAOB)
2. **Reduced conflict of interest**
 - Unlawful if public accounting firm provides any non-audit service to a client with an impermissible audit
3. **Provided incentives for investment banks not to exploit conflicts of interests**
 - Criminal charges for white-collar crime and obstruction of official investigation
4. **Improved the quality of information in the financial markets**
 - CEO, CFO, and auditors are required to certify periodic financial statements and disclosures of the firm
 - Independent members of the audit committee

58

Global Legal Settlement of 2002

1. Reduced conflict of interest

- Required to sever the links between research and securities underwriting
- Banned spinning

2. Provided incentives for investment banks not to exploit conflict of interest

- Imposed \$1.4 billion of fines on the accused investment banks

59

Global Legal Settlement of 2002

3. Implemented measures to improve the quality of information in financial markets

- Require investment banks to make public their analysts' recommendations

60

Public Action Reform

Sarbanes-Oxley Act of 2002

- ▣ Increased supervisory oversight to monitor and prevent conflicts of interest
- ▣ Reduced conflicts of interest
- ▣ Produced incentives for investment banks not to exploit conflicts of interest
- ▣ Instituted measures to improve the quality of information in financial markets

Global Legal Settlement of 2002

- ▣ Directly reduced conflicts of interest
- ▣ Produced incentives for investment banks not to exploit conflicts of interest
- ▣ Instituted measures to improve the quality of information in financial markets

61

Remedy Approaches

Leave It To The Market

- ▣ The market may punish the firm exploiting conflicts of interest by causing them to have higher funding costs or decreased demand for services
- ▣ Open market forces can create means to contain conflicts of interest through information demanded from non conflicted organizations

Regulate For Transparency

- ▣ Mandatory information disclosure decreases information asymmetries
 - ▣ This in turn reveals if conflicts of interest are being exploited
 - ▣ Could be bad because of free-loader effect
 - ▣ If regulated too much can cause loss in information production and profitability for the firm

62

Remedy Approaches

Supervisory Oversight

- ▣ Supervisors can review financial information without revealing it to competitors
 - ▣ This maintains profitability & information production
- ▣ Supervisors can then take actions to control the exploitation of conflicts of interest and enforce ethical standards
 - ▣ Poor supervisors allow for exploitation to continue

Separation Of Functions

- ▣ Reduces economies of scope through regulation
 - ▣ Information sharing between departments is regulated
- ▣ Separates departments and adds firewalls to ensure that the firms agents are not responding to multiple principals
 - ▣ Results in a trade off between information production and reducing conflicts of interest

63

Conflict of Interest



64

Insider Trading & Market Abuse

- The Securities Industry Act, 2011 of the Commonwealth of The Bahamas defines insider dealing in Sections 74-77 as:
- Creating a false market (manipulating prices with misinformation) as defined in Section 69 in SIA, 2011
- The Securities Industry Act, 2011 defines market rigging as companies in a market acting together to stop a market working as it should in order to gain an unfair advantage.

65

Evaluation of Insider Trading

Pros

- ✓ Sends “soft information” to markets – thus protecting proprietary info
- Encourages insiders to own company stock
- Compensates insiders for developing “good news”

Cons

- Unfair to those without information
- Discourages investors from entering market
- Adds to trading “spreads” in markets
- Constitutes theft of corporate intellectual property
- Distorts company disclosures as insiders manipulate company info

66

66

Types of Insider Trading

- Classic Insider Trading:
 - Fraudulent silence under Section 10(b)
 - Duty of trust and confidence to “abstain or disclose”
 - Actionable silence in confidential relationships
- Tipping:
 - Tippee knows or should know that
 - Tipper breached duty for direct/indirect personal benefit
 - Necessary to extend prohibition from tipping
- Misappropriation (Outsider Trading):
 - Duty of trust and confidence to source
 - Fraud on source “in connection with” securities trading
 - Maintain integrity of securities markets

67

67

FCA - EU Market Abuse Directive

What is the Market Abuse Directive?

The Market Abuse Directive came into force on 1 July 2005. It is a law that aims to fight (cross-border) market abuse by establishing a common approach among EU member states.

68

68

FCA Market Abuse Provisions

The purpose of these provisions is to deter abusive behaviour which could undermine confidence in the UK financial markets and which, if unchecked, would ultimately damage the integrity (faith) of those markets.

69

69

Behaviors That Amount to Market Abuse

1. **Insider Dealing** – when an insider deals, or tries to deal, on the basis of inside information. **Improper disclosure and misuse of information** are kinds of insider dealing.

For Example:

- ✓ An employee finds out that his company is about to become the target of a takeover bid.
- ✓ Before the information is made public, he buys shares in his company because he knows a takeover bid may be imminent.
- ✓ He then discloses the information to a friend. This behaviour creates an unfair market place because the person who sold the shares to the employee might not have done so if he had known of the potential takeover.
- ✓ The employee's friend also has this information and could profit unfairly from it.

70

70

Behaviors That Amount to Market Abuse

2. Improper Disclosure – where an insider improperly discloses inside information to another person.

3. Misuse of Information – behaviour based on information that is not generally available but would affect an investor's decision about the terms on which to deal.

71

71

Behaviors That Amount to Market Abuse

Example

- An employee learns that his company may lose a significant contract with its main customer.
- The employee then sells his shares, based on his assessment that it is reasonably certain the contract will be lost.
- This behaviour creates an unfair market place as the person buying the shares from the employee might not have done so had he been aware of the information about the potential loss of the contract

72

72

Market Abuse

4. Manipulating Transactions – trading or placing orders to trade, that gives a false or misleading impression of the supply of, or demand for, one or more investments, raising the price of the investment to an abnormal or artificial level.

73

73

Market Abuse

Example

- ❑ A person buys a large number of a particular share near the end of the day, aiming to drive the stock price higher to improve the performance of their investment.
- ❑ The market price is pushed to an artificial level and investors get a false impression of the price of those shares and the value of any portfolio or fund that holds the stock.
- ❑ This could lead to people making the wrong investment decisions.

74

74

Market Abuse

5. Manipulating Devices – trading or placing orders to trade, which employs fictitious devices or any other form of deception or contrivance.

Example

- Buying shares and then spreading misleading information with a view to increasing the price.
- This could give investors a false impression of the price of a share and lead them to make the wrong investment decisions.

75

75

Market Abuse

6. Dissemination – giving out information that conveys a false or misleading impression about an investment or the issuer of an investment where the person doing this knows the information to be false or misleading.

76

76

Market Abuse

Example:

- ❖ A person uses an internet bulletin board or chat room to post information about the takeover of a company.
- ❖ The person knows the information to be false or misleading.
- ❖ This could artificially raise or reduce the price of a share and lead to people making the wrong investment decisions.

77

77

Market Abuse

7. Distortion and Misleading Behaviour – behaviour that gives a false or misleading impression of either the supply of, or demand for, an investment; behaviour that otherwise distorts the market in an investment.

78

78

Market Abuse

Example:

- ❖ The movement of an empty cargo ship that is used to transport a particular commodity.
- ❖ This could create a false impression of changes in the supply of, or demand for, that commodity or the related futures contract.
- ❖ It could also artificially change the price of that commodity or the futures contract, and lead to people making the wrong investment decisions.

79

79

Market Abuse

What Is 'Inside Information'?

- This is precise information that is not generally available and that a reasonable investor would use to help them make investment decisions.
- It is also information that, if generally available, would be likely to significantly affect the price of an investment.

80

80

Market Abuse

Example:

- ▣ Information from research or analysis is deemed to be generally available, and is not inside information.
- ▣ For example, if a passenger on a train passing a burning factory calls their broker and instructs them to sell shares in the company that owns the factory, the passenger would be acting on information that is generally available.
- ▣ This is because they obtained it legitimately by observing a public event.

81

81

Insider Trading



82

82

Compliance Culture & Risk Management

To Create An Effective Compliance Culture:

- Understand the existing compliance culture;
- Assess the risk appetite of the organization
- Identify and minimize cultural barriers
- Manage and mitigate risks
- Educate and train Stakeholders
- Make everyone accountable
- Constantly evaluate and adapt the culture

83

Compliance Culture & Risk Management

- ❑ Culture is how an organization behaves i.e. what it does or how it acts, rather than what it says or gives lip service to – internally and externally.
- ❑ Unlike policy documents or procedure manuals, the culture of an organization and its attitude towards risk are intangible and therefore both difficult to assess and influence.
- ❑ The key question in determining or developing compliance culture in any organization is first asking, What is the risk appetite of the organization? Is the organization prepared or willing to assume the risk?

84

Compliance Culture & Risk Management

What constitutes an effective compliance culture?

- Effective Risk Management
- Good Corporate Governance i.e. Board of Directors' and Senior Management Buy-In
- Good Ethics

85

Ethics & Duty of Confidentiality

Under common law and statutory law (Bank and Trust Companies Regulation Act/Central Bank of the Bahamas Act), there is a duty not to disclose a client's financial affairs unless one or more of the four exceptions applies:

- ▣ Duty to disclose under compulsion of law
- ▣ Duty to disclose in the public's interest
- ▣ Duty to disclose in the bank's interest
- ▣ Duty to disclose by the express or implied consent of the customer

86



87

AML & The Proceeds of Crime Act, 2000

- Sections 40 to 44 of The Proceeds of Crime Act, 2000 (“POCA”) create four main money laundering offences:
 1. The transfer and conversion of property with the intent to conceal or disguise the property.
 2. Having reasonable grounds to suspect that property represents another person’s proceeds of criminal conduct and using, transferring, sending, delivering, or disposing of property with the intent to conceal or disguise the property.

88

AML & The Proceeds of Crime Act, 2000

3. Assisting another to conceal the proceeds of criminal conduct

4. Acquiring, possessing or using the proceeds of crime, knowing or suspecting or having reasonable grounds to suspect that any property directly or indirectly represents another person's proceeds of criminal conduct

89

AML & The Proceeds of Crime Act, 2000

Types of Orders under POCA

- Production Orders – Powers of investigation for the purpose of a criminal confiscation order
- Monitoring Orders – Allows law enforcement to observe for 90 days re confiscation and AML investigations
- Enforcement Orders – Order to take possession – usually by the courts
- Search Warrants – Authorizes the proper officer to enter and search specified premises and to seize assets from the proceeds of crime.

90

Alternative Dispute Resolution & The Risk Management Process

“If you come to help me, then you are wasting my time. But if you come here because your liberation is bound up in mine, then let us begin.”

Lily Walker

91

91

Arbitration Mediation & Litigation

■ Arbitration :

A form of alternative dispute resolution where the parties to a dispute agree to submit their matter by agreement or hearing to a neutral third party for his determination.

It is based primarily on contract law and its rules of evidence/questioning of witnesses are less stringent than in litigation.

92

Arbitration Mediation & Litigation

▣ Mediation:

A form of alternative dispute resolution between two parties where a third party, the mediator, assists the parties in negotiating their own settlement through dialogue, facilitation, reasoning, and problem solving.

93

Arbitration Mediation & Litigation

▣ Litigation:

An action brought in court to enforce a legal right, pursue a claim, and seek a legal remedy to a problem or conflict between parties.

94

Regulatory Vs Compliance Risks

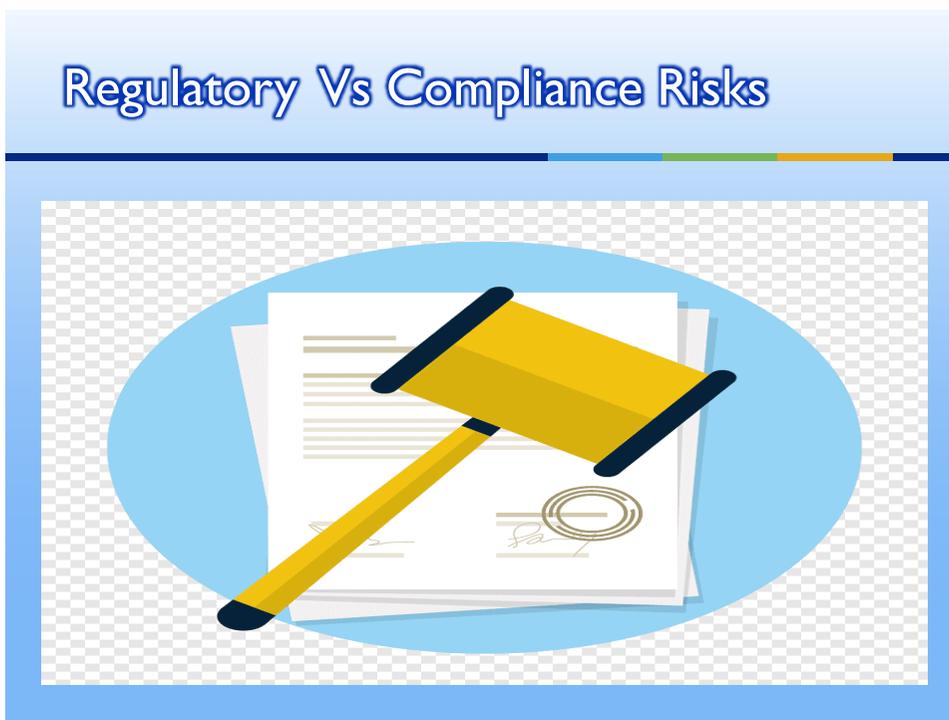
ie
INTEGRITY

Regulatory vs. compliance risks

<p>● Regulatory risks</p> <ul style="list-style-type: none"> ● Potential loss caused by the creation or modification of laws and regulations, or their interpretation ● Caused by the government or regulator ● Increase costs of doing business, restrict activities or affect the competition ● Anticipate to changes in laws and regulations 	<p>● Compliance risks</p> <ul style="list-style-type: none"> ● Potential loss caused by a breach of a internal standard, contract, law, regulation or ethical value ● Caused by internal controls failures, a defective transaction or a legal claim ● Accidental, deliberate or negligent misconduct breaches ● Fines, payment of damages, voided contracts, or affect the reputation ● Prevention and contingency plans
--	---

95

Regulatory Vs Compliance Risks



96

Module VI

Reputational Risk & Corporate Governance

- Reputational Risk – what it is and how to manage it
- Working with professionalism and Ethics – some ethical dilemmas
- Corporate Governance – Duties of Board and management
- Independent Directors. Executive and Non Executive Directors
- Relations with Shareholders and other Stakeholders
- Financial Disclosure and Non Financial Disclosure

Lecturer: Christine Archer
Third Edition, June 2021

Reputation Risk & Corporate Governance

- Reputation Risk – Case Study**
- Definition of Reputation**
- Reputation vs. Image**
- Reputation vs. Brand**
- Reputation Risk**
- Determinants of Reputation Risk**
- Managing Reputation Risk**
- Reputation Risk Monitoring**
- Challenges of Reputation Risk Management**
- Best Practices for effective Reputation Risk Management**
- Reputation Risk and Corporate Governance**
- The Link between Reputation Risk and Corporate Governance**
- Cost of Reputation**
- Drivers of Reputation Risk**
- Reputation and Risk Management**
- Checklist for Mitigating Reputation Risk**
 - Reputation Who is responsible**

Ethics & Professionalism

- What Is Business Ethics?**
- The Cost of Poor Ethical Decisions in Business**
- Common Business Ethical Problems**
- Making Sound Ethical Decisions - A Checklist**
- The 10-Step Method of Ethically-based Decision-making**
- Corporate Social Responsibility (CSR)**
- The Legal vs. Ethical Debate**

Corporate Governance

- Corporate Governance Overview**
 - Definition of Corporate Governance**
 - Responsibilities of the Board**
 - Corporate Governance Initiatives**
 - Duties of the Board**
- Executive and Non-Executive Directors**
- The Role of Non-Executive Directors**
- Relations with Shareholders and Stakeholders**
 - G20/OECD Corporate Principles**
 - Financial Disclosure and Non-Financial Disclosures**
 - G20/OECD Corporate Principles**
 - Case Studies**

Appendices

Reputation Risk



Case Study: The Johnson & Johnson Tylenol Crisis

Before the crisis, Tylenol was the most successful over-the-counter product in the United States with over one hundred million users. Tylenol was responsible for 19 percent of Johnson & Johnson's corporate profits during the first 3 quarters of 1982. Tylenol accounted for 13 percent of Johnson & Johnson's year-to-year sales growth and 33 percent of the company's year-to-year profit growth. Tylenol was the absolute leader in the painkiller field accounting for a 37 percent market share, outselling the next four leading painkillers combined, including Anacin, Bayer, Bufferin, and Excedrin. Had Tylenol been a corporate entity unto itself, profits would have placed it in the top half of the Fortune 500 (Berger, 1998).

During the fall of 1982, for reasons not known, a malevolent person or persons, presumably

unknown, replaced Tylenol Extra-Strength capsules with cyanide-laced capsules, resealed the packages, and deposited them on the shelves of at least a half-dozen or so pharmacies, and food stores in the Chicago area. The poison capsules were purchased, and seven unsuspecting people died a horrible death. Johnson & Johnson, parent company of McNeil Consumer Products Company which makes Tylenol, suddenly, and with no warning, had to explain to the world why its trusted product was suddenly killing people (Berge, 1998).

Primary Evidence. Robert Andrews, assistant director for public relations at Johnson & Johnson recalls how the company reacted in the first days of the crisis: "We got a call from a Chicago news reporter. He told us that the medical examiner there had just given a press conference-people were dying from poisoned Tylenol. He wanted our comment. As it was the first knowledge we had here in this department, we told him we knew nothing about it. In that first call we learned more from the reporter than he did from us." Andrew's dilemma points out something that has become more prevalent with the expansion of 24 hour electronic media. The media will often be the first on the scene, thus have information about the crisis before the organization does (Berge, 1990).

Johnson & Johnson chairman, James Burke, reacted to the negative media coverage by forming a seven-member strategy team. The team's strategy guidance from Burke was first, "How do we protect the people?" and second "How do we save this product?" The company's first actions were to immediately alerted consumers across the nation, via the media, not to consume any type of Tylenol product. They told consumers not to resume using the product until the extent of the tampering could be determined. Johnson & Johnson, along with stopping the production and advertising of Tylenol, withdraw all Tylenol capsules from the store shelves in Chicago and the surrounding area. After finding 2 more contaminated bottles Tylenol realized the vulnerability of the product and ordered a national withdraw of every capsule (Broom, 1994).

By withdrawing all Tylenol, even though there was little chance of discovering more cyanide laced tablets; Johnson & Johnson showed that they were not willing to take a risk with the public's safety, even if it cost the company millions of dollars. The end result was the public viewing Tylenol as the unfortunate victim of a malicious crime (Broom, 1994).

Johnson & Johnson also used the media, both PR and paid advertising to communicate their strategy during the crisis. Johnson & Johnson used the media to issue a national alert to tell the public not to use the Tylenol product. In the first week of the crisis Johnson & Johnson established a 1-800 hot line for consumers to call. The company used the 1-800 number to respond to inquires from customers concerning safety of Tylenol. They also

establish a toll-free line for news organizations to call and receive pre-taped daily messages with updated statements about the crisis (Berge, 1990).

Before the crisis Johnson & Johnson had not actively sought press coverage, but as a company in crisis they recognized the benefits of open communications in clearly disseminating warnings to the public as well as the company's stand (Broom, 1994).

Several major press conferences were held at corporate headquarters. Within hours an internal video staff set up a live television feed via satellite to the New York metro area. This allowed all press conferences to go national. Jim Burke got more positive media exposure by going on 60 Minutes and the Donahue show and giving the public his command messages (Fink, 1986).

Johnson & Johnson communicated their new triple safety seal packaging- a glued box, a plastic seal over the neck of the bottle, and a foil seal over the mouth of the bottle, with a press conference at the manufacturer's headquarters. Tylenol became the first product in the industry to use the new tamper resistant packaging just 6 months after the crisis occurred (Berge, 1990).

Secondary Evidence. The initial media reports focused on the deaths of American citizens from a trusted consumer product. In the beginning the product tampering was not known, thus the media made a very negative association with the brand name.

All 3 networks lead with the Tylenol story on the first day of the crisis. CBS put a human face on the story which contained the following: "When 12 year-old Mary Kellerman of Elk Grove Village, Ill., awoke at dawn with cold symptoms; her parents gave her one Extra-Strength Tylenol and sent her back to bed. Little did they know, they would wake up at 7:00 a.m. to find their daughter dying on the bathroom floor." (Kaplin, pg. 1, 1998) The print media weighed in with equally damaging headlines: Time Magazine, "Poison Madness in the Midwest," Newsweek, "The Tylenol Scare," The Washington Post, "Tylenol, Killer or Cure."

The media was not only focused on the deaths but it was also pervasive. Throughout the crisis over 100,000 separate news stories ran in U.S. newspapers, and hundreds of hours of national and local television coverage. A post crisis study by Johnson & Johnson said that over 90 percent of the American population had heard of the Chicago deaths due to cyanide-laced Tylenol within the first week of the crisis. Two news clipping services found

over 125,000 news clippings on the Tylenol story. One of the services claimed that this story had been given the widest US news coverage since the assassination of President John F. Kennedy (Kaplin, 1998).

Media reporting would continue to focus on Tylenol killing people until more information about what caused the deaths was made available. In most crises media will focus on the sensational aspects of the crisis, and then follow with the cause as they learn more about what happened.

Scholarly Journals. Scholars have come to recognize Johnson & Johnson's handling of the Tylenol crisis as the example for success when confronted with a threat to an organization's existence. Berge lauds the case in the following manner, "The Tylenol crisis is without a doubt the most exemplary case ever known in the history of crisis communications. Any business executive, who has ever stumbled into a public relations ambush, ought to appreciate the way Johnson & Johnson responded to the Tylenol poisonings. They have effectively demonstrated how major business has to handle a disaster." (pg. 19, 1990)

The Tylenol case was the bases for many of the crisis communications strategies developed by researchers over the last 20 years. Berg's suffering strategy and Benoit's Rectification strategies both were developed from doing case studies of how Johnson & Johnson handled the Tylenol poisonings (Coombs, 1995).

Discussion. The crises category in the Johnson & Johnson Tylenol case is Terrorism. Combs defines terrorism as intentional actions taken by external actors designed to harm the organization directly (hurt employees or customers) or indirectly (reduce sales or disrupt production). Product tampering, hostage taking, sabotage, and workplace violence are examples of terrorism. The violent, outside agent promotes attributions of external locus and uncontrollability.

The Tylenol product tampering clearly fits the Terrorism category. An external agent, presumably, acted to hurt the customers and possibly the employees of Johnson & Johnson. The other categories, Faux Pas, Accidents, or Transgression do not fit in the Tylenol case, so there was no cross-categorization in this case.

Crisis Response Strategies used by Johnson & Johnson: Johnson & Johnson employed

Forgiveness and Sympathy strategy for this crisis. Forgiveness strategy seeks to win forgiveness from the various public and create acceptance for the crisis.

Johnson & Johnson used Remediation and Rectification, both Forgiveness strategies, in the Tylenol crisis. Remediation offers some form of compensation to help victims of the crisis. Johnson & Johnson provided the victim's families counseling and financial assistance even though they were not responsible for the product tampering. Negative feelings by the public against Johnson & Johnson were lessened as the media showed them take positive actions to help the victim's families (Berg, 1990).

Rectification involves taking action to prevent a recurrence of the crisis in the future. Johnson & Johnson's development of Triple sealed packaging is an example of rectification. They also developed new random inspection procedures before the shipment of Tylenol to retailers (Berg, 1990).

Sympathy strategy was a big component of Johnson & Johnson's crisis communication strategy. Sympathy strategy wins support from the public by portraying the organization as the unfair victim of an attack from an outside entity. Johnson & Johnson's willingness to accept losses by pulling the Tylenol product developed sympathy with the public (Berg & Robb, 1992).

The Johnson & Johnson Tylenol crisis is an example of how an organization should communicate with the various public during a crisis. The organization's leadership set the example from the beginning by making public safety the organizations number one concern. This is particularly important given the fact that Johnson & Johnson's main mission with Tylenol is to enhance the public's well-being or health.

Although Johnson & Johnson's leadership performed superbly during the crisis there were some important areas Tylenol improved upon after the crisis. Johnson & Johnson did not have a proactive public affairs program before the crisis. The only media relations engaged in by Johnson & Johnson was in the advertising and marketing area. In the early stages of the crisis Tylenol was informed about what was going on from a Chicago reporter. If this

particular reporter had been more contentious or adversarial the whole crisis may have taken on a different form in the public's perception.

Johnson & Johnson's failure to employ/establish a positive relationship with the media, a key stakeholder, forced the company to respond to the crisis in an advertising-like manner. Johnson & Johnson received criticism from the media for not being genuine due to the slick sales-like response ads run during the crisis. The personal messages with the media from the CEO of the organization enabled Johnson & Johnson to overcome this problem.

Today Johnson & Johnson has completely recovered its market share lost during the crisis. The organization was able to reestablish the Tylenol brand name as one of the most trusted over-the-counter consumer products in America. Johnson & Johnson's handling of the Tylenol crisis is clearly the example other companies should follow if they find themselves on the brink of losing everything.

<https://www.ou.edu/deptcomm/dodjcc/groups/02C2/Johnson%20&%20Johnson.htm>

What is 'reputation'?

Jonathan Low and Pam Cohen Kalafut in *The Invisible Advantage* defined reputation as the following:

'In a sense a company's reputation is the ultimate intangible. It's literally nothing more than how the organisation is perceived by a variety of people. It is slippery, volatile, easily compromised, impossible to control, amorphous'.

Reputation is hard to pin down in monetary terms despite the fact that damage ultimately carries a cost. It makes reputation risk a particular challenge to internal auditors and risk managers.

Reputation is not synonymous with brand, goodwill or image. A brand is a consumer proposition created and managed by its owner in order to generate revenue. A reputation is a perception held by others about the company, in anticipation of future behavior. Goodwill is an accounting term for the intangible value of customer loyalty. Image is a one-dimensional mental picture without the future or historic element present in reputation.

The nature of reputation can be viewed in different ways. In some cases businesses consider their reputation with shareholders or investors to be the most critical, after investor confidence which refers to market capitalization and share price. This relational construct

of 'reputation' also considers customers, suppliers or employees to also be important as a business cannot exist without them.

A business may have more than one reputation: a good reputation with customers and a poor reputation with its suppliers. This poses to the board of directors certain strategic questions:

1. is reputation with one group more important than another?
2. should the business take notice of all stakeholders' concerns?
3. should the business prioritize?

To a business reputation is attributed for some action or behavioral characteristic that sets the company apart from competitors or peers. For investors it could be for delivery of dividends as promised, for customers it could be delivery of value for money; and employees it could be having a good pension plan. By attributing reputation by exception, it presumes that the stakeholder group has some knowledge of competitors and peers in order to make the comparison.

Reputation management is about managing expectation and avoiding surprises which draws attention to performance above or below expectation. Reputation is a relative concept and reflects the environment in which we operate as much as our own actions.

Alternatively, reputation can be seen as being based on perception, it doesn't have to rely on truth or reality but on a combination of the experience, knowledge and belief of stakeholders. A company has the capacity to improve a stakeholder experience and some ability to improve stakeholder knowledge but relatively little power to influence belief. If a stakeholder group believes your company is fraudulent, there is very little you can do to dissuade it.

A good reputation is not easily won and commonly hard earned. A bad reputation can attach itself quickly and prove very difficult to correct. Building a good reputation is not something a business does consciously, as a good reputation is a by product of good management. Organisations that acquire a good reputation do so because they are managing the issues which are business critical not necessarily reputation critical.

Basically when a business looks at its reputation it is seen as a valuable endorsement of trust by its stakeholders. When stakeholders become disillusioned this causes damage to a business' reputation – the stakeholders' value judgment fails – confidence is eroded.

In businesses reputation is rarely measured. It usually shows up as the gap between book value and market capitalization. It is a part of the intellectual capital of a business as it has a huge value in attracting new clients, employees and investors.

So what underpins reputation?

Professionalism underpins a good reputation. A good reputation attracts and a bad reputation repels. A good reputation is slowly earned amongst stakeholders, a bad reputation is quickly assigned by the same stakeholders. A business should be mindful that not all stakeholder groups share the same perspective. The quality of reputation of a business is determined by its behavior, good or bad, within the context of the market or local environment.

In summary:

First, some general definitions about reputation:

- Reputation is public information regarding a business' trustworthiness. A business' reputation reflects the information that stakeholders have on how trustworthy its behavior has been in the past.

(Ripperger 1998)

- A corporate reputation is a collective representation of a firm's past actions and results that describe the firm's ability to deliver outcomes to multiple stakeholders. It gauges a firm's relative standing both internally and externally.

(Fombrun & Foss: Developing a Reputation Quotient, 2000)

- Any organization's reputation derives from a mix of the rational and emotional attachments that stakeholders form with it. Unlike image, which is a more immediate external perception of an organization and may be one element of reputation, reputation is built up over a longer period and is about the integrity of an organization. It is the result of a collection of memories, perceptions and opinions, influenced by every event, contact, public statement, media reference, rumour or leak about that organization. It is as much about impressions, beliefs and feelings as about experiences and knowledge. But perception strongly influences – or can become – reality.

A good reputation means the business is perceived to match stakeholders' values, while a bad one means it is not.

(Marion Turner - Reputation, Risk and Governance, February 2004)

- **“Reputation vs. Image**

-

- **Reputation:**

- Corporate actions and conduct that create trust as experienced by different stakeholders
- Serves as a reservoir of goodwill in time of crisis
- It's what you are, not what you want to be

- **Image:**
 - Belief in and personal evaluation of a firm or brand
 - Tied to the firm or brand directly, not to a firm's actions

- **Correlation between Reputation and Image:**
 - If image is positive, reputation may improve.
 - If reputation is positive, image will improve
 - Reputation evolves more slowly than image because reputation is tied to actions.

(Anthony Baynes, Hellenic Coca Cola presentation, October 24, 2008)

Reputation vs. Brand

- **Brand:**
 - What differentiates the business from its competitors
 - Marketing of the company including advertising and publicity
 - Refers to logos and names of companies
 - How we present ourselves – what we create

- **Reputation:**
 - Cannot be enhanced by just a name change
 - Larger concept as it includes other elements
 - Often referred to as “Emotional Capital” of the firm
 - Thus, if capital, it is subject to risk
 - Our status in the minds of others – what we earn

(Michel Rochette, Towers Perrin, May 9, 2007)

Reputation Risk

The following article appeared in February 2007 by Robert G. Eccles, Scott C. Newquist, and Roland Schatz

From the Magazine

Summary.

“Regulators, industry groups, consultants, and individual companies have developed elaborate guidelines over the years for assessing and managing risks in a wide range of areas, from commodity prices to natural disasters. Yet they have all but ignored reputational risk, mostly because they aren’t sure how to define or measure it.

That’s a big problem, say the authors. Because so much market value comes from hard-to-assess intangible assets like brand equity and intellectual capital, organizations are especially vulnerable to anything that damages their reputations. Moreover, companies with strong positive reputations attract better talent and are perceived as providing more value in their products and services, which often allows them to charge a premium. Their customers are more loyal and buy broader ranges of products and services. Since the market believes that such companies will deliver sustained earnings and future growth, they have higher price-earnings multiples and market values and lower costs of capital.

Most companies, however, do an inadequate job of managing their reputation in general and the risks to their reputation in particular. They tend to focus their energies on handling the threats to their reputation that have already surfaced. That is not risk management; it is crisis management—a reactive approach aimed at limiting the damage. The authors provide a framework for actively managing reputational risk. *They introduce three factors (the reputation-reality gap, changing beliefs and expectations, and weak internal coordination) that affect the level of such risks and then explore several ways to sufficiently quantify and control those factors.*

Executives know the importance of their companies’ reputation. Firms with strong positive reputation attract better people. They are perceived as providing more value, which often allows them to charge a premium. Their customers are more loyal and buy broader ranges of products and services. Because the market believes that such companies will deliver sustained earnings and future growth, they have higher price-earnings multiples and market values and lower costs of capital. Moreover, in an economy where 70% to 80% of market value comes from hard-to-assess intangible assets such as brand equity, intellectual capital, and goodwill, organizations are especially vulnerable to anything that damages their reputation.

“It takes many good deeds to build a good reputation, and only one bad one to lose it.”—Benjamin Franklin

Given this lack of common standards, even sophisticated companies have only a fuzzy idea of how to manage reputational risk. A large U.S. pharmaceutical company reflects the current state of practice among well-run organizations. It has an ERM system for managing operational and financial risks, as well as hazards from external events such as natural

disasters, that is loosely based on the COSO framework. The firm's vice president of risk management oversees the system. However, the company manages reputational risks only informally—and unevenly—at the local and product levels. Its leaders consider reputational risk only when they make major decisions such as those involving acquisitions. (The company's due-diligence process includes the evaluation of problems that could affect reputation, including pending lawsuits, weak product-testing procedures, product-liability concerns, and poor control systems for detecting management fraud.) The risk management VP says that reputational risk is not included in the long list of risks for which he is responsible. *Then who is responsible?* The CEO, the vice president surmises, since that is who oversees the firm's elaborate crisis-response system and is ultimately responsible for dealing with any events that could damage the company's reputation. This pharmaceutical firm is not alone. Contingency plans for crisis management are as close as most large and midsize companies come to reputational-risk management. While such plans are important, it is a mistake to confuse them with a capability for managing reputational risk.

Determinants of Reputational Risk

Three things determine the extent to which a company is exposed to reputational risk.

- 1. Whether its reputation exceeds its true character.**
- 2. How much external beliefs and expectations change, which can widen or (less likely) narrow this gap.**
- 3. The quality of internal coordination, which also can affect the gap.**

Reputation-reality gap

Effectively managing reputational risk begins with recognizing that reputation is a matter of perception. A company's overall reputation is a function of its reputation among its various stakeholders (investors, customers, suppliers, employees, regulators, politicians, nongovernmental organizations, the communities in which the firm operates) in specific categories (product quality, corporate governance, employee relations, customer service, intellectual capital, financial performance, handling of environmental and social issues). A strong positive reputation among stakeholders across multiple categories will result in a strong positive reputation for the company overall.

Reputation is distinct from the actual character or behavior of the company and may be better or worse. When the reputation of a company is more positive than its underlying reality, this gap poses a substantial risk. Eventually, the failure of a firm to live up to its billing will be revealed, and its reputation will decline until it more closely matches the reality. BP appears to be learning this the hard way. The energy giant has striven to portray itself as a responsible corporation that cares about the environment. Its efforts have included its extensive "Beyond Petroleum" advertising campaign and a multi billion-dollar initiative to expand its alternative-energy business. But several major events in the past two years are now causing the public to question whether BP is truly so exceptional. One was the explosion and fire at its Texas City refinery in March 2005 that killed 15 people and injured scores of others. Another was the leak in a corroded pipeline at its Prudhoe Bay oil field

in Alaska that occurred a year later and forced the company to slash production in August 2006. BP has blamed the refinery disaster on lax operating practices, but federal investigators have alleged that cost cutting contributed as well. Employee allegations and company reports suggest that the root cause of the Prudhoe Bay problem may have been inadequate maintenance and inspection practices and management's failure to heed warnings of potential corrosion problems. As media coverage reflects, these events and others have damaged BP's reputation.

To bridge reputation-reality gaps, a company must either improve its ability to meet expectations or reduce expectations by promising less. The problem is, managers may resort to short-term manipulations. For example, reputation-reality gaps concerning financial performance often result in accounting fraud and (ultimately) restatements of results. Computer Associates, Enron, Rite Aid, Tyco, WorldCom, and Xerox are some of the well-known companies that have fallen into this trap in recent years.

“Character is like a tree and reputation like its shadow. The shadow is what we think of it; the tree is the real thing.”—Abraham Lincoln

Of course, organizations that actually meet the expectations of their various stakeholders may not get full credit for doing so. This often occurs when a company's reputation has been significantly damaged by unfair attacks from special interest groups or inaccurate reporting by the media. It also can happen when a company has made genuine strides in addressing a problem that has hurt its reputation but can't convince stakeholders that its progress is real. For example, Chrysler, Ford, and General Motors improved their cars so much that the quality gap between them and the vehicles made by Japanese companies had largely closed by 2001. Yet, much to the frustration of the Big Three, consumers remain skeptical.

Undeserved poor or mediocre reputations can be maddening. The temptation is to respond to them with resignation and conclude: “No matter what we do, people won't like us, so why bother?” The reason executives should bother—through redoubled efforts to improve reporting and communications—is that their fiduciary obligation to close such reputation-reality gaps is as great as their obligation to improve real performance. Both things drive value creation for shareholders.

Changing beliefs and expectations.

The changing beliefs and expectations of stakeholders are another major determinant of reputational risk. When expectations are shifting and the company's character stays the same, the reputation-reality gap widens and risks increase.

There are numerous examples of once-acceptable practices that stakeholders no longer consider to be satisfactory or ethical. Until the 1990s, hostile takeovers in Japan were almost unheard of—but that was partly due to the cross-holding of shares among the elite groups of companies known as keiretsu, a practice that undermined the power of other shareholders. With the weakening of the keiretsu structure during the past ten to 15 years, shareholder rights and takeovers have been on the rise. In the United States, once-acceptable practices now considered improper include brokerage firms using their

research functions to sell investment-banking deals; insurance underwriters' incentive payments to brokers, which caused brokers to price and structure coverage to serve underwriters' interests rather than customers'; the appointment of CEOs' friends to boards as "independent directors"; earnings guidance; and smoothing of earnings.

Sometimes norms evolve over time, as did the now widespread expectation in most developed countries that companies should pollute minimally (if at all). A change in the behavior or policies of a leading company can cause stakeholders' expectations to shift quite rapidly, which can imperil the reputations of firms that adhere to old standards. For example, the "ecomagination" initiative launched by General Electric in 2005 has the potential to raise the bar for other companies. It committed GE to doubling its R&D investment in developing cleaner technologies, doubling the revenue from products and services that have significant and measurable environmental benefits, and reducing GE's own greenhouse emissions.

Of course, different stakeholders' expectations can diverge dramatically, which makes the task of determining acceptable norms especially difficult. When GlaxoSmithKline (GSK) pioneered the development of anti-retroviral drugs to combat AIDS, its reputation for conducting cutting-edge research and product development was reinforced and shareholders were pleased. They were initially on board when GSK led a group of pharmaceutical companies in suing the South African government after it passed legislation in 1997 allowing the country to import less expensive, generic versions of AIDS drugs covered by GSK patents. But in 2001, GSK shareholders did an about-face in reaction to an intensifying campaign waged by NGOs and to the trial proceedings, which made GSK and the other drug companies look greedy and immoral. With its reputation plunging, GSK relented and granted a South African company a free license to manufacture generic versions of its AIDS drugs—but the damage was already done.

Sometimes, particular events can cause latent concerns to burst to the surface. One example would be all the questions about whether Merck had fully disclosed the potential of its painkiller Vioxx to cause heart attacks and strokes. Merck is embroiled in thousands of lawsuits over the arthritis drug, which it pulled from the market in 2004. The controversy has raised patients' and doctors' expectations that drug companies should disclose more detailed results and analyses of clinical trials, as well as experience in the market after drugs have received regulatory approval.

When such crises strike, companies complain that they have been found guilty (in the courts or in the press) because the rules have changed. But all too often, it's their own fault: They either ignored signs that stakeholders' beliefs and expectations were changing or denied their validity.

In addition, organizations sometimes underestimate how much attitudes can vary by region or country. For example, Monsanto, a developer of genetically modified plants, was badly burned by its failure to anticipate Europeans' deep concerns about genetically modified foods.

Weak internal coordination.

Another major source of reputational risk is poor coordination of the decisions made by different business units and functions. If one group creates expectations that another group fails to meet, the company's reputation can suffer. A classic example is the marketing department of a software company that launches a large advertising campaign for a new product before developers have identified and ironed out all the bugs: The company is forced to choose between selling a flawed product and introducing it later than promised.

The timing of unrelated decisions also can put a company's reputation at risk, especially if it causes a stakeholder group to jump to a negative conclusion. This happened to American Airlines in 2003, when it was trying to stave off bankruptcy. At the same time that it was negotiating a major reduction in wages with its unions, its board approved retention bonuses for senior managers and a big payment to a trust fund designed to protect executive pensions in the event of bankruptcy. However, the company didn't tell the unions. Furious when they found out, the unions revisited the concessions package they had approved. The controversy cost CEO Donald J. Carty his job.

Poor internal coordination also inhibits a company's ability to identify changing beliefs and expectations. In virtually all well-run organizations, individual functional groups not only have their fingers on the pulses of various stakeholders but are also actively trying to manage their expectations. Investor Relations (with varying degrees of input from the CFO and the CEO) attempts to ascertain and influence the expectations of analysts and investors; Marketing surveys customers; Advertising buys ads that shape expectations; HR surveys employees; Corporate Communications monitors the media and conveys the company's messages; Corporate Social Responsibility engages with NGOs; and Corporate Affairs monitors new and pending laws and regulations. All of these actions are important to understanding and managing reputational risks. But more often than not, these groups do a bad job of sharing information or coordinating their plans.

Coordination is often poor because the CEO has not assigned this responsibility to a specific person. When 269 executives were asked in 2005 by the Economist Intelligence Unit who at their companies had "major responsibility" for managing reputational risk, 84% responded, "The CEO." This means that nobody is really overseeing the coordination process. Yes, the CEO is the person ultimately responsible for reputational risk, since he or she is ultimately responsible for everything. But the fact of the matter is, the CEO does not have the time to manage the ongoing process of coordinating all the activities that affect reputational risk.

Managing Reputational Risk – 5 Steps

Effectively managing reputational risk involves five steps:

1. **assessing your company’s reputation among stakeholders,**
2. **evaluating your company’s real character,**
3. **closing reputation-reality gaps,**
4. **monitoring changing beliefs and expectations,**
5. **and putting a senior executive below the CEO in charge.**

Assess reputation

Since reputation is perception, it is perception that must be measured. This argues for the assessment of reputation in multiple areas, in ways that are contextual, objective, and, if possible, quantitative. Three questions need to be addressed: What is the company’s reputation in each area (product quality, financial performance, and so on)? Why? How do these reputations compare with those of the firm’s peers?

Various techniques exist for evaluating a company’s reputation. They include media analysis, surveys of stakeholders (customers, employees, investors, NGOs) and industry executives, focus groups, and public opinion polls. Although all are useful, a detailed and structured analysis of what the media are saying is especially important because the media shape the perceptions and expectations of all stakeholders.

Today, many companies hire clipping services to gather stories about them. Text- and speech-recognition technologies enable these services to scan a wide range of outlets, including newspapers, magazines, TV, radio, and blogs. They can provide information on such things as the total number of stories, the number per topic, and the source and author of each story. While useful in offering a real-time sample of media coverage, these services are not always accurate in assessing whether a story about a company is positive, negative, or neutral, because of the limits of the computer algorithms that they employ. They also tend to miss stories that cite a company but do not mention it in the headline or first few sentences.

Therefore, the old tool of clipping services needs to be supplemented with strategic media intelligence. This new tool not only analyzes every line in a story but also places the coverage of a company within the context of all the stories in the leading media (those that set the tone for the coverage of topics, companies, and people in individual countries). Since the reputation of a company is a function of others’ reputations in its industry and the relative reputation of the industry overall, having the complete context is essential for assessing volume and prominence of coverage, topics of interest, and whether the view is positive or negative.

Establishing a positive reputation through the media depends on several factors or practices, according to research by the Media Tenor Institute for Media Analysis (founded by coauthor Roland Schatz) in Lugano, Switzerland.

First, the company has to land and remain on the public's radar screen, which involves staying above what we call the "awareness threshold": a minimum number of stories mentioning or featuring the company in the leading media. This volume, which must be continual, varies somewhat from company to company, depending on industry and country but not on company size.

Second, a positive reputation requires that at least 20% of the stories in the leading media be positive, no more than 10% negative, and the rest neutral. When coverage is above the awareness threshold and is positive overall, the company's reputation benefits from individual positive stories and is less susceptible to being damaged when negative stories appear. If coverage is above the awareness threshold but the majority of stories are negative, a company will not benefit from individual positive stories, and bad news will reinforce its negative reputation. All companies—large or small—should care about staying above their awareness threshold. Even if a small company has a very strong reputation among a small group of core investors or customers, it runs a high risk of suffering considerable damage to its reputation if its media coverage is below the awareness threshold when a crisis hits.

A company's reputation is also vulnerable if the media are focused on just a few topics, such as earnings and the personality of the CEO. Even if the coverage of these topics is extremely favorable, a negative event outside these areas will have a much larger negative impact than it would have if the firm had enjoyed broader positive coverage.

Third, managers can influence the mix of positive, negative, and neutral stories by striving to optimize the company's "share of voice": the percentage of leading-media stories mentioning the firm that quote someone from the organization or cite data it has provided. Media Tenor's research suggests that a company needs to have at least a 35% share of voice in order to keep the proportion of negative stories to a minimum in normal times. Strong relationships and credibility with the press are crucial to attaining a large share of voice and are especially important during a crisis, when a company really needs to communicate its point of view. In such times, management's share of voice needs to be at least 50% to ensure that critics of the company don't prevail. Merck's travails after the problems with Vioxx illustrate the consequences of a company inadequately managing its position in the media. That is, Merck had a low profile prior to the Vioxx problems.



Evaluate reality

Next, the company must objectively evaluate its ability to meet the performance expectations of stakeholders.

Gauging the organization's true character is difficult for three reasons:

- First, managers—business unit and functional heads as well as corporate executives—have a natural tendency to overestimate their organizations' and their own capabilities.
- Second, executives tend to believe that their company has a good reputation if there is no indication that it is bad, when in fact the company has no reputation in that area.
- Finally, expectations get managed: Sometimes they are set low in order to ensure that performance objectives will be achieved, and other times they are set optimistically high in an attempt to impress superiors or the market.

As is the case in assessing reputation, the more contextual, objective, and quantitative the approach to evaluating character, the better. Just as the reputation of a company must be assessed relative to competitors, so must its reality. For example, performance-improvement targets based only on a company's results for the previous year are meaningless if competitors are performing at a much higher level. The importance of bench-marking financial and stock performance and processes against peers' and those of companies regarded as "best in class" is hardly a revelation. However, the degree of sophistication and detail as well as the accuracy or reliability of bench-marking data can vary enormously. The reasons include transcription errors (a big problem when a large amount of data in paper documents has to be manually entered into electronic spreadsheets), for instance, and the inability to determine whether the way competitors report information in an area is consistent. One company might include customers' purchases of extended warranties in its revenues, while another might not.

Close gaps

When a company's character exceeds its reputation, the gap can be closed with a more effective investor relations and corporate communications program that employs the principles of strategic media intelligence discussed above. If a reputation is unjustifiably positive, the company must either improve its capabilities, behavior, and performance or moderate stakeholders' perceptions. Of course, few companies would choose the latter if there were any way to accomplish the former. If, however, the gap is large, the time required to close it is long, and the damage if stakeholders recognize the reality is likely to be great, then management should seriously consider lowering expectations—although this obviously needs to be done in careful, measured ways.

Monitor changing beliefs and expectations

Understanding exactly how beliefs and expectations are evolving is not easy, but there are ways to develop a picture over time. For instance, regular surveys of employees, customers, and other stakeholders can reveal whether their priorities are changing. While most well-run companies conduct such surveys, few take the additional step of considering whether the data suggest that a gap between reputation and reality is materializing or widening. Similarly, periodic surveys of experts in different fields can identify political, demographic, and social trends that could affect the reputation-reality gap. “Open response” questions can be used to elicit new issues of importance—and thus new expectations—that other questions might miss. It is generally useful to supplement these surveys with focus groups and in-depth interviews to develop a deeper understanding of the causes and possible consequences of trends.

Influential NGOs that could make the company a target are one group of stakeholders that should be monitored. These include environmental activists; groups concerned about wages, working conditions, and labor practices; consumers’ rights groups; globalization foes; animals’ rights groups, climate change groups. Many executives are skeptical about whether such organizations are genuinely interested in working collaboratively with companies to achieve change for the public good. But NGOs are a fact of life and must be engaged. Interviews with them can also be a good way of identifying issues that may not yet have appeared on the company’s radar screen.

Finally, companies need to understand how the media shape the public’s beliefs and expectations. Dramatic changes in the amount of coverage influence how fast and to what extent beliefs and expectations change. The large volume and prominent display of stories on the backdating of stock options in recent months is one example of how the media can help set the agenda. The sharp drop in stories about insurance brokers’ getting incentive payments from underwriters illustrates how the media can help relegate a hot topic to the back burner.

Put one person in charge

Assessing reputation, evaluating reality, identifying and closing gaps, and monitoring changing beliefs and expectations will not happen automatically. The CEO has to give one person responsibility for making these things happen. Obvious candidates are the COO, the CFO, and the heads of risk management, strategic planning, and internal audit. They have the credibility and control some of the resources necessary to do the job. In general, those whose existing responsibilities pose potential conflicts probably shouldn’t be chosen. People holding top “spin” jobs, such as the heads of marketing and corporate communications, fall into this category. So does the general counsel, whose job of defending the company means his relationship with stakeholders is often adversarial and whose typical response to media inquiries is “no comment.”

The chosen executive should periodically report to top management and the board on what the key reputational risks are and how they are being managed. It is up to the CEO or the board to decide whether the risks are acceptable and, if not, what actions should be taken.

In addition, top management and the board should periodically review the risk-management process and make suggestions for improving it.

Regardless of size and industry, it is imperative for organizations to manage their reputation carefully. Just as a strong reputation can help attract new business, a poor reputation can drive potential customers away, leading to financial loss. This is why many organizations are beginning to invest in reputational risk management program

Reputational Risk Monitoring

With a system in place to manage enterprise risk, companies are able to set quantifiable performance metrics and facilitate reputational alignment across departments. This streamlines a businesses' ability to identify and respond to reputational threats by enabling risk prioritization. Below we outline four best practices you can follow to effectively manage reputational risk at your organization.

As more businesses begin to digitize, reputational strength has become more important than ever before. Organizations are facing increased levels of cybersecurity, financial, and compliance risk, which, if mismanaged, can lead to significant reputational losses. This is why it is vital that organizations build reputational risk management systems that monitor enterprise-wide cybersecurity.

Challenges of reputational risk management

The key challenge many businesses face in managing reputational risk is identifying potential risk events. The lack of widely accepted standards for how to categorize and rank reputational risk makes it difficult for businesses to accurately assess and manage threats. In addition, reputational risks can be extremely complex and span across multiple departments, meaning it can take a long time to identify new threats and vulnerabilities. Reputational risk management requires building frameworks that unify threat identification. The challenge is that this process is resource-intensive and requires open communication between the board of directors and the security teams responsible for managing the risk.

4 Best Practices for Effective Reputational Risk Management

By Negin Aminian (POSTED ON JAN 13, 2021)

1. Establish board oversight

Effective risk management requires ongoing board oversight. When creating a reputational risk management program be sure to coordinate with board members with regard to all strategy and policy decisions. The goal is to create a system that allows for constant communication between risk management teams and the board so that stakeholders are always aware of security efforts. The board can also provide valuable insight into which risks to prioritize based on their knowledge of organizational goals and procedures.

2. Integrate your reputational risk strategy into business planning

Integrating your reputational risk management strategy with core business processes ensures that it is factored into business planning. In order to get the most out of these risk management strategies, it is important that directors and executives understand the different aspects of your plan of action, so that they can devote the necessary resources to risk management teams. Doing so will also help you set informed performance metrics as they relate to your organization's goals and available budget.

3. Create incident response plans

While risk management programs help limit reputational risk exposure, no strategy is ever one hundred percent effective. In the event that you do encounter an event that poses risk to your organization's reputation, it is essential that you have an incident response plan in place. An incident response plan is a predetermined set of actions that an organization follows in order to mitigate the overall impact of events that could have adverse effects on reputation. When creating an incident response plan, first create internal teams who will be responsible for guiding your organization's actions in the case of an event. From there, you should define individual employee roles so that everyone at your organization knows what to do if and when an incident occurs. In order to streamline risk response, be sure to also create a checklist of action items that should be prioritized.

4. Ensure third-party risk management

If your organization works with third-party vendors, then it is critical that you manage their risk as you would your own. Vendors have access to critical systems and customer data, which must be carefully monitored as to avoid any potential risk events. Taking a risk-based approach to vendor management can not only help limit potential reputational risk events associated with third-parties but can also help you identify areas of improvement within your organization. Some key vendor risks that should be monitored daily include:

Cybersecurity risk: Cybersecurity risk is concerned with any potential losses resulting from a cyber attack or breach of your organization's systems.

Compliance risk: Compliance risk arises from violations of the laws, regulations, and internal processes your organization follows to conduct business.

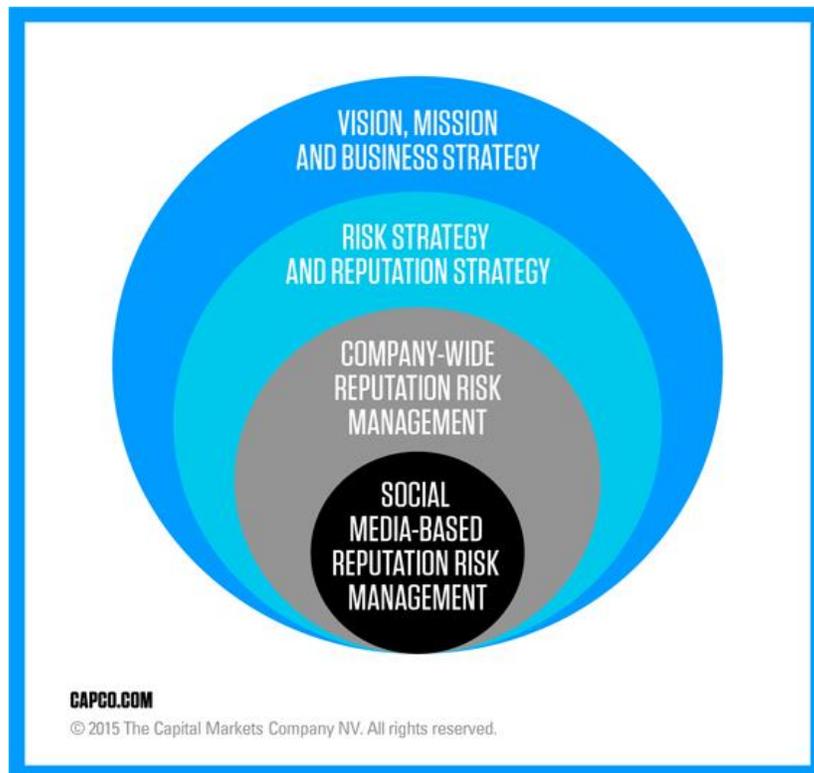
Financial risk: Third-party financial risk occurs when vendors do not meet the fiscal performance requirements put in place by your organization.

Strategic risk: Strategic risk occurs when a vendor's actions or business decisions do not align with your organization's strategic goals.

[Any example of software is SecurityScorecard which streamlines reputational risk management. With SecurityScorecard's suite of enterprise risk management solutions, organizations gain unprecedented visibility into critical risks with their business ecosystem.

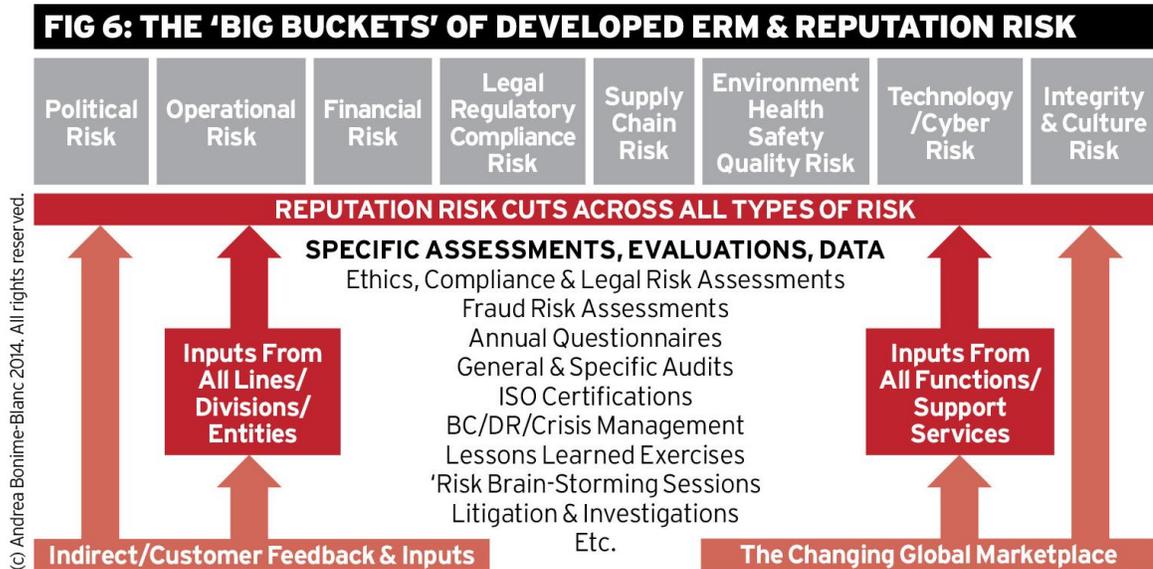
Security Ratings offer easy-to-read A-F ratings across ten groups of risk factors, helping the business to drill down and prioritize cyber threat remediation. It also limits vendor risk by offering third-party risk management tools that actively detect potential gaps in security while ensuring that vendors are always in compliance with relevant regulations. This allows the business to actively manage vendor relationships and address third party reputational risk in real-time.]

With business environments becoming increasingly distributed and cyber threats growing in complexity, continuously monitoring reputational risk is imperative to organizational success. With SecurityScorecard, organizations are able to take a proactive approach to reputational risk management and ensure business objectives are met.



Reputation Risk and Corporate Governance

Reputation Risk is emerging as a Key Risk as companies focus on enterprise risk management:



- **Why Corporate Governance?**

One may ask the following questions, “Why focus on corporate governance?” or, “Why the new/renewed quest for a set of rules to direct how we operate business on a daily basis nowadays?”

The answers to these questions seem to be tied to the fact that as a society we appear to have lost our way...our moral compass...our sense of right and wrong. Issues that were once ‘black and white’ have become ‘gray’.

- **What has reputation to do with governance?**

One of the primary causes of the loss of reputations in the business world, is poor governance. Poor governance can destroy the reputation of a business and the personal reputations of board members and management. There are many cases of board-room casualties and damaged personal reputations. There were Marks & Spencer, BCCI, Hollinger and Equitable Life, to name a few.

Most corporate governance disasters happen because the non-executives become too close to, or blindly trust, the executive management team.

1. The Key Link Between Corporate Governance and Reputational Risk

In the wake of corporate collapses and lapses in leadership, it has become very clear that there is a strong link between reputation, governance and risk. Risk needs to be given a higher profile at board level, and directors and top management need to be aware that it is their responsibility to be alert to new and emerging risks, particularly reputational risk. Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term

within appropriate risk parameters that are established, understood and engaged in by the board.

(Arif Zaman – Reputation Institute, and Henley Business School)

2. Examples of Reputation Risk in Recent Years

- **Mercedes** – In 1997, the company was caught off guard when its new A-class car embarrassingly rolled over during a test to simulate being hit by an elk.

- **WorldCom** – When this company collapsed in 2002, its investors lost billions, and so did shareholders of Citigroup. Markets punished the financial giant for its part in the scandal. Citigroup had risked its reputation by developing a web of intimate business relationships with the fraud-ridden telecoms firm. Citigroup equity analysts had been apparently writing reports on WorldCom for Citigroup customers, while at the same time the financial services group had been advising WorldCom's Board on strategy. Citigroup also lent money to WorldCom, issued and underwrote securities and advised its pension fund. Citigroup's asset managers held a large chunk of WorldCom shares. Citigroup even lent money to private businesses run by WorldCom's head, Bernie Ebbers (who was sentenced to a 25-year jail term)

(Professor Ingo Walter – INSEAD)

- **Enron's experience with risk management**
 - Maintained a risk management function
 - Lines of reporting were reasonably independent
 - Mark-to-market valuations were subject to adjustments by management
 - Few career risk managers
 - Fluid workforce
 - Employees constantly looking for next transfer

(The Edcomm Group Banker's Academy)

- ***The Tyco International scandal refers to the 2002 theft by former company CEO and Chairman Dennis Kozlowski and former corporate Chief Financial Officer Mark Swartz of as much as \$600 million from the firm. Court proceedings proved that he stole millions of dollars from Tyco, and that his illegal financial transactions were extensive. Kozlowski and CFO Mark Swartz were convicted***

and imprisoned in 2005. In the aftermath of the scandal, Tyco's business performance declined and investors lost confidence in the company

Rite Aid shareholders this morning approved a \$9-per-share takeover offer from Walgreens. The move marks the end of an era for Rite Aid, a Pennsylvania-grown, East Pennsboro Township-based company that grew into the third-largest pharmacy company in the nation, only to be bedeviled by corporate fraud, various management issues and deep debts born of its acquisition binges.

- Some other examples that you may wish to read up on (via the internet):
 - Marks & Spencer
 - British Airways, Reuters
 - Dell
 - FedEx
 - Barclays
 - Perrier – Toluene traces (used to make benzene)

 - Exxon – Valdez spill
 - Union Carbide – Bhopal, India

 - Arthur Andersen – Enron shredding

 - Firestone – Tires

Confidence in big business

	Great deal	Quite a lot	Some	Very little	None (vol.)	No opinion	Great deal/Quite a lot
	%	%	%	%	%	%	%
2020	7	12	45	33	3	1	19
2019	10	13	41	32	2	*	23
2018	10	15	43	29	1	1	25
2017	9	12	38	36	3	1	21
2016	6	12	43	36	2	1	18
2015	9	12	41	34	3	1	21
2014	9	12	38	35	5	2	21
2013	9	13	43	31	2	2	22
2012	9	12	40	34	4	2	21

BIFS Certified International Risk Manager Programme Module VI – Reputation Risk & Corporate Governance

	Great deal	Quite a lot	Some	Very little	None (vol.)	No opinion	Great deal/Quite a lot
	%	%	%	%	%	%	%
2011	8	11	41	35	4	2	19
2010	7	12	42	35	3	1	19
2009	6	10	42	36	5	1	16
2008	7	13	43	32	3	2	20
2007	7	11	39	38	3	2	18
2006	6	12	40	36	4	2	18
2005	8	14	45	29	2	2	22
2004	7	17	42	30	3	1	24
2003	8	14	44	31	2	1	22
2002	7	13	47	29	3	1	20
2001	10	18	44	23	3	2	28
2000	9	20	45	22	2	2	29
1999	11	19	44	24	1	1	30
1998	11	19	43	23	2	2	30
1997	11	17	43	24	3	2	28
1996	7	17	46	26	2	2	24
1995	8	13	50	24	2	3	21
1994	9	17	42	28	2	2	26
1993	7	16	44	28	3	2	23
1991 Oct	7	15	42	30	2	4	22
1991 Feb	11	15	45	22	3	4	26
1990	9	16	40	28	3	4	25
1988	7	18	42	26	4	3	25
1986	7	21	40	26	2	4	28
1985	8	24	41	22	2	4	32
1984	9	20	39	28	--	4	29
1983	7	21	39	26	2	5	28
1981	6	14	36	29	11	3	20

	Great deal	Quite a lot	Some	Very little	None (vol.)	No opinion	Great deal/Quite a lot
	%	%	%	%	%	%	%
1979	11	21	37	26	2	3	32
1977	11	21	35	25	2	6	32
1975	10	24	36	23	2	5	34
1973	10	16	36	20	9	8	26

(vol.) = Volunteered response; * Less than 0.5%

GALLUP

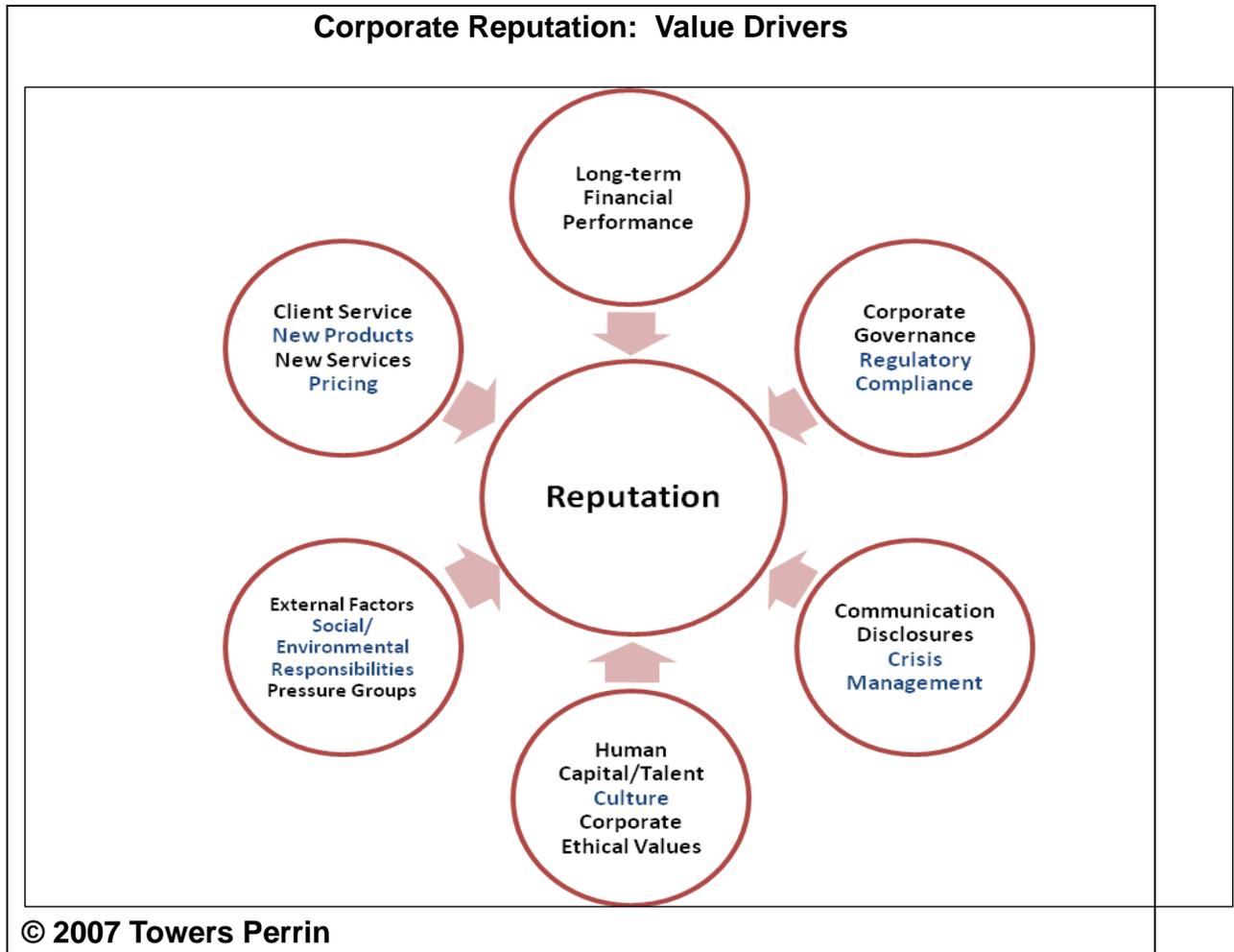
- **The Cost of Reputation**

- Companies have found that reputational problems are the most costly in financial terms relative to other risks.
- Among those that faced reputational problems:
 - ✓ 28% described the financial toll as major
 - ✓ 18% described the loss of key skills and talent as the next severe problem (although 52% identified this as a source of minor losses)
- Many companies allocate up to 70% of the value of their companies as “goodwill”; so, it is no wonder that reputation ranks high among the risks they face.

3. Who Are The Key Stakeholders of Reputation Risk?

- **Class Exercise** – Participants will be asked to identify the various stakeholders (first column), and will then separate into 2 to 3 groups of four or more persons to determine the risk related to each of the agreed stakeholders (2nd column). Thereafter, each group will orally present their list of corresponding related risks which will be discussed as necessary.

Participants will use the spreadsheet provided overleaf. The first key stakeholder and the related reputation risk has been completed.



- Long-term Financial Performance (& Long-term Investment Value)
- Corporate Governance, Regulatory Compliance & Leadership
- Communication, Disclosures & Crisis Management
- Human Capital/Talent, Culture & Corporate Ethical Values
- External Factors, Social/Environmental Responsibilities & Pressure Groups (i.e. Corporate Responsibility)
- Client Services, New Products, New Services, & Pricing (Customer Service Delivery)

- **Reputation Drivers Create Value to the Firm**

- A good reputation encourages consumers to buy products and services

- Suppliers are willing to do business with you, thus expanding opportunities
- Top notch employees want to join and stay with your organization, thus enhancing its innovation capabilities and value
- Favorable outlook from regulators and rating agencies, thus decreasing financing cost and increasing value
- Investors want to hold shares, thus increasing value
- Positive feedback from media and pressure groups increase value
- In a crisis mode, investors give the company the benefit of the doubt, thus easing short-term decrease in value

(Michel Rochette, Towers Perrin, May 9, 2007)

5. Benefits of Effective Reputation Management

- Improves relations with shareholders
- Creates a more favorable environment for investment
- Recruits/retains the best employees
- Reduces barriers to development in new markets
- Secures premium prices for products
- Minimizes threats of litigation

(The Edcomm Group Banker's Academy)

6. Reputation & Reputation Risk Management



- Unlike the scenario depicted in the “Dogbert” cartoon above, the key to managing reputational risk is sound RISK MANAGEMENT, coupled with straightforward communication about the problem that the organization is facing.
- **All crises are unique, but share the following traits:**
 - The element of surprise

- Insufficient information
- Quick pace of events
- Intense scrutiny

- **Key steps required for a strategic response to a crisis:**
 - Defining the situation
 - Setting the objectives
 - Developing messages
 - Organizing the response process
 - Delivering a response

Successful reputation management involves identifying key stakeholders and understanding them and those who influence them. This involves identifying the issues that need managing and the opportunities for getting news and information to the right audiences.

Managing issues is often about:

- Closing gaps between stakeholders' awareness and actual performance;
- Managing stakeholders' expectations by:
 - Nurturing and promoting the association's strengths;
 - Identifying, addressing and managing weaknesses.

The key is to recognize and define the issues before they impact and to take positive, planned action to defuse them rather than having to react hurriedly and defensively. So, to avoid being taken by surprise, organizations should scan, monitor and track potentially influential external forces. They should analyze those forces in terms of their effects on an organization's image, financial performance and ability to deliver. Based on that analysis, an organization can develop and implement a strategy for managing its reputation.

To monitor, report and review reputation and reputation risk, any organization needs to analyze and understand the strengths, weaknesses, opportunities and threats of and to its reputation.

A Checklist for Mitigating Reputational Risk

- **General:**

- Clear and well-communicated business vision, values, and strategy that set the right ethical and stakeholder-awareness tone for the business
- Supporting policies and codes of conduct that guide employee behavior and decision-making so that goals are achieved in accordance with business values
- Extension of the business' values and relevant policies to key partners in the supply chain
- Dialogue and engagement to track the changing perceptions, requirements, and expectations of major stakeholders continuously
- An effective enterprise-wide risk management system that identifies, assesses, responds to, monitors, and reports on threats and opportunities to reputation
- A culture in which employees are risk-aware, are encouraged to be vigilant, raise concerns, highlight opportunities, and act as reputational ambassadors for the business
- Transparent communications that meet stakeholder needs and build trust and confidence
- Robust and well-rehearsed crisis management arrangements
- **Specific Risks:**
 - Evaluate the risk in the usual way, by considering the likelihood of the risk occurring and the impact if it does
 - Identify the key stakeholders – Understand them and what they regard as current and emerging major issues. Also, what do they expect of us?

- Quantify the risk in monetary terms – e.g. expected reduced income resulting from loss of customers, or impact on share price

- Develop and document a response plan to manage the specific risk that presents unacceptable exposure for the business. Identify possible gaps between customer experience and expectation and our values and delivery

- Regularly measure external perceptions of the company

- Systematically track reputational threats

- Train employees to identify and manage the specific reputational risk

- Publically set standards on environmental, human rights and labor practices

- Establish relationships and trust with pressure groups and other potential critics

7. Asking the Following Questions May Also Help to Uncover Reputation Risks:

- What newspaper headline about your business would you least (or most) like to see? What could trigger this?

- What could threaten your core business values or your license to operate? Such risks can seriously damage reputation and lead to an irreversible loss of stakeholder confidence.

- Could there be collateral risk arising from the activities of another player in your sector? If so, the reputation of your own business may be vulnerable and come under intense stakeholder scrutiny.

- Could reputation risk exposure arise from an acquisition, merger, or other portfolio change? A mismatch of values, ethos, culture, and standards resulting

in inappropriate behavior could seriously damage reputation. Conversely, if the acquisition target enjoys a superior reputation, it could provide a competitive edge.

Reputation: Who is Responsible?

- The board of a business is the ultimate custodian of a business's reputation. However, managing reputation risk successfully requires a team effort across the business from executive and nonexecutive directors, senior and middle managers, public relations staff, risk and audit professionals, and key business partners.
- Everyone employed by and indirectly working for a business should be expected to uphold the business' values and bear some responsibility for spotting emerging risks that could impact reputation. The telltale signs of an imminent crisis are often missed because personnel are not risk-aware: A spate of customer complaints, safety near-misses or supplier non-conformances, a sudden rise in employee turnover, or pressure group activity - these can act as crucial early warning indicators which allow a business to take corrective action and avert disaster.

Case Study 1

- **Allied Irish Banks**

Case Study –

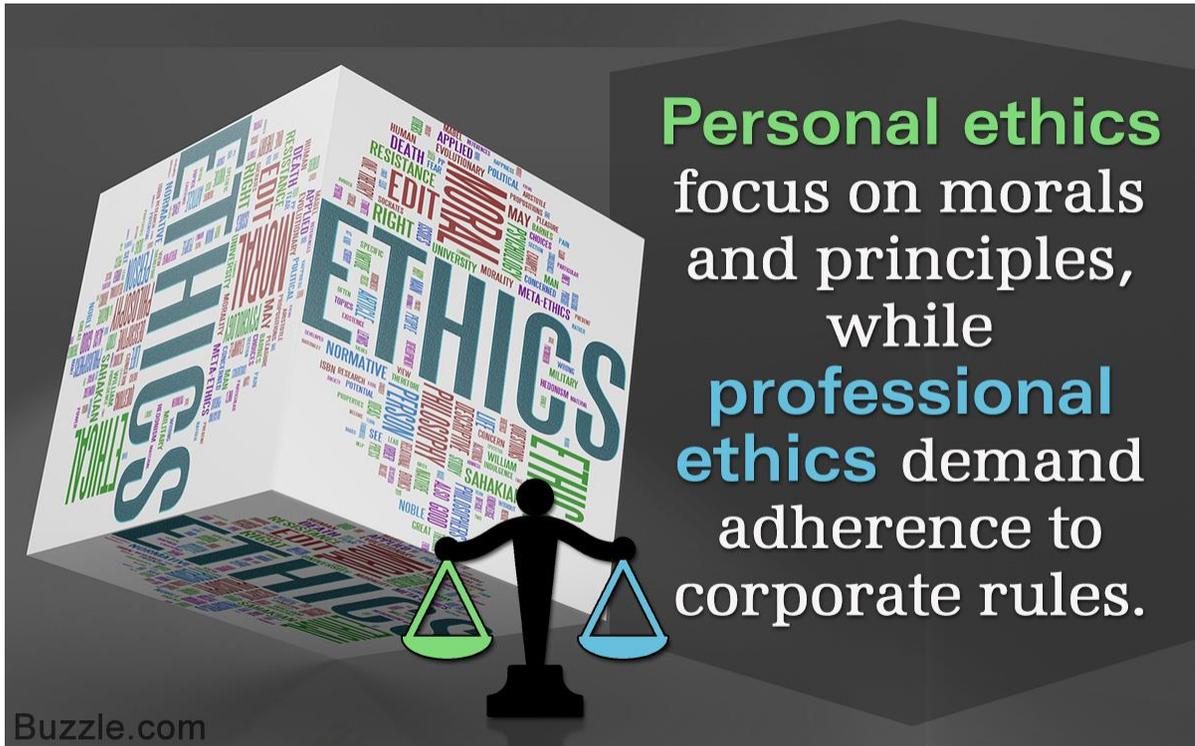
- **2019 Australian banking scandals**

Conclusion

- A good reputation hinges on a business living the values it claims to espouse and delivering consistently on the promise to its stakeholders.
- Successfully managing reputation risk is both an inside and outside challenge. The inside component requires business leaders to establish an appropriate vision, values and strategic goals that will guide actions and behaviors throughout the organization.
- Active and systematic management of the risks to reputation can help to ensure that perception is aligned with reality, and that stakeholder experience matches expectations.

(Jenny Raynor, Understanding Reputation Risk and its Importance)

Professionalism and Ethics



1. What is Business Ethics?

- **Some Definitions:**

- ❖ Also known as Corporate Ethics, it is a form of applied ethics or professional ethics that examines ethical principles and moral or ethical problems that arise in a business environment. It applies to all aspects of business conduct and is relevant to the conduct of individuals and entire organizations. (**Wikipedia**)
- ❖ Made up of a society's (cultural) values, norms and laws. (**Anonymous**)
- ❖ A system of moral principles. The rules of conduct recognized in respect to a particular class of human actions or a particular group, culture, etc. (e.g. Medical ethics, Christian ethics). (**www.dictionary.reference.com/browse/ethics**)

- **Some Quotes:**

“Can you tell me, Socrates, whether virtue is acquired by teaching or by practice, or if by neither by teaching nor practice, then whether it comes to man by nature, or in what other way?”

(**Plato's Meno: Question to Socrates**)

“We judge ourselves by our intentions: We judge others by their actions....”

[Anonymous speaker at the 28th Annual ICAC (Accountants) Conference, 2010 addressing the issue of Business Ethics.]

- **So, What is Business Ethics?**

Business ethics focuses on identifying the moral standards of right and wrong as they apply to behavior within and across business institutions and other related organizations.

Corporations sometimes behave unethically, having a harmful effect on people or the environment.

Unethical behavior is typically not caused by a single “bad apple,” but is a result of complex interactions between individuals, groups, and organizational cultures.

Ethical behavior can be defined either as behavior that maximizes happiness and minimizes harm, or as behavior that is motivated by principles of duty.

While behaving unethically may have some short-term benefit for a company, in the long term it will harm stakeholder support.

Long-term sustainability comes from concentrating on the *triple bottom line*: that is, *social*, environmental, and financial performance (Elkington, 1998).

(Sue Newell, QFINANCE (www.qfinance.com), “Business Ethics”.)

2. The Cost of Poor Ethical Decisions in Businesses

In his address at the 19th World Conference of Bankers Institutes (WCBI) held in the Bahamas in 2011 on the topic, “Integrity Matters – You be the Judge”, Simon Culhane of the Chartered Institute for Securities and Investment (CISI), stated that many of the corporate failures were due to a lack of integrity.

Mr. Culhane cited the example of **Satynam**, an Indian Computer Company based in the United Kingdom. The company had indicated that they employed 54k people, but there were only 40k in reality. The executives pocketed the salaries of the 14k supposed employees.

When making a business decision, Culhane’s philosophy is to ask four questions. Is it:

- Honest?
- Open?
- Transparent?
- **Fair?**

Poor ethical decisions cost corporations millions and millions of dollars, both in terms of opportunities lost, due to loss of sales as a result of unfavourable public opinion and in payouts to executives whose contracts must be terminated as a result of the unethical decision(s) made.

The chart below indicates the massive amounts of money paid out in severance packages to CEOs of ten corporations where CEO decisions were, to say the least, questionable, if not outright unethical.

	COMPANY	CEO	YEAR	ESTIMATED SEVERANCE PAYOUT
1	ExxonMobil	Lee Raymond	2006	\$351 million
2	Pfizer	Hank (Henry) McKinnell	2006	\$213 million
3	Home Depot	Robert Nardelli	2007	\$210 million
4	Gillette	James Kilts	2005	\$165 million
5	Merrill Lynch	Stanley O'Neal	2007	\$161.5 million
6	UnitedHealth	William McGuire	2006	\$153 million
7	Wellpoint Health Networks	Leonard Schaeffer	2005	\$137 million
8	South Trust Bank	Wallace Malone	2006	\$135 million
9	Morgan Stanley	Philip Purcell	2005	\$94 million
10	Conseco	Stephen Hilbert	2000	\$72.5 million

(Source: Corporate Library) - Courtesy of: <http://www.bloomberg.com/>

3. Common Business Ethical Problems

“Given the increasing social impact of business, business ethics has emerged as a discrete subject over the last 20 years. Business ethics is concerned with exploring the moral principles by which we can evaluate business organizations in relation to their impact on people and the environment. Trevino and Nelson (2004) categorize four types of ethical problems that are commonly found in business organizations.

First are the human resource problems: These relate to the equitable and just treatment of current and potential employees. Unethical behavior here involves treating people

unfairly because of their gender, sexuality, skin color, religion, ethnic background, and so on.

Second are ethical problems arising from *conflicts of interest*, when particular individuals or organizations are given special treatment because of some personal relationship with the

individual or group making a decision. A company might get a lucrative contract, for example, because a bribe was paid to the management team of the contracting organization, not because of the quality of its proposal.

Third are ethical problems that involve *customer confidence*. Corporations sometimes behave in ways that show a lack of respect for customers or a lack of concern with public safety. Examples here include advertisements that lie (or at least conceal the truth) about particular goods or services, and the sale of products, such as drugs, where a company conceals or obfuscates negative data about safety and/or efficacy.

Finally, there are ethical problems surrounding the *use of corporate resources by employees* who make private phone calls at work, submit false expense claims, take company stationery home, etc.

The financial scandals that have rocked the corporate world in recent years (Enron, WorldCom, Parmalat, Lehman Brothers, for example) have involved a number of these different ethical issues. In these cases, senior managers have engaged in improper bookkeeping, making companies look more financially profitable than they actually are. As a consequence the stockholder value of the company increases, and anyone with stock profits directly. Among those profiting will be those making the decisions to manipulate the accounts—and so there is a conflict of interest. However, the fallout from the downfall of these companies affects stockholders, employees, and society at large negatively, with innocent people losing their retirement reserves and/or savings, and employees losing their jobs.

Another category can be added to this list—ethical problems surrounding the *use of the world's environmental resources*. Many organizations have externalized the costs associated with their negative impact on the environment, whether in relation to their own operations to produce goods and services, or in terms of the use and later the disposal of the goods that they have sold.

Externalizing means that organizations do not themselves pay for the environmental costs that they create. For example, carbon dioxide emissions, a by-product of energy use for all kinds of organizations, are now recognized as contributing to global warming; computer equipment contains toxic waste that pollutes the land where it is dumped; and packaging of all kinds, including plastic bags that are handed out by supermarkets, are creating mounting problems as local authorities run out of landfill sites.

Increasingly, ethical business is seen to require that a business takes into account and offsets its “environmental footprint” so that it engages in sustainable activity. Sustainability broadly means that a business meets the needs of the present without compromising the ability of future generations to meet their needs.

Accounting for Ethical and Unethical Behavior:

While it may be very easy to identify and blame an individual or small group of individuals, to see these individuals as the perpetrators of an unethical act—the “bad apple”—and hold them responsible for the harm caused, is an oversimplification. Most accounts of unethical behavior that are restricted to the level of the individual are inadequate. **Despite popular belief, decisions harmful to others or the environment that are made within organizations are not typically the result of an isolated, immoral individual seeking to gain personally.** Although an individual’s level of moral maturity or the locus of control (for example, the degree to which they perceive they control their behaviors and actions) are factors, we also need to explore the decision-making context—the group dynamics and the organizational practices and procedures—to understand why an unethical decision was made.

The degree to which decisions are ethical is also influenced by organizational culture or climate. Organizational ethical climates can differ; some are more egoistic, others are more benevolent, still others are highly principled, and these contexts can shape a manager’s ethical decision-making.

Smith and Johnson (1996) identify three general approaches that organizations take to corporate responsibility:

- **Social obligation:** The corporation does only what is legally required.
- **Social responsiveness:** The corporation responds to pressure from different stakeholder groups.
- **Social responsibility:** The corporation has an agenda of proactively trying to improve society.

In a company in which the dominant approach to business ethics is social obligation, it is likely to be difficult to justify a decision based on ethical criteria; morally irresponsible behavior may be condoned as long as it does not break the law. Legal loopholes, for example, may be exploited in such a company if these can benefit the company in the short term, even if they might have a negative influence on others in society.

Ethical Dilemmas:

Sometimes it is clear that a business has behaved unethically—for example, where a drug is sold illegally, the company accounts have been falsely presented, or where client funds have been embezzled. Of more interest, and much more common, are situations that pose an ethical dilemma—situations that present a conflict between right and wrong or between values and obligations—so that a choice is necessary. For example, a corporation may want to build a new factory on a previously undeveloped

and popular tourist site in a location where there is large-scale unemployment among the local population. Here we have a conflict between the benefits of wealth and job creation in a location in which these are crucial and the cost of spoiling some naturally beautiful countryside. Philosophers have attempted to develop prescriptive theories providing universal laws that enable us to differentiate between right and wrong, and good and bad, in these situations.

Prescriptive Ethical Theories:

Essentially there are two schools of thought. The **Consequentialists** argue that behavior is ethical if it maximizes the common good (happiness) and minimizes harm. The opposing **Nonconsequentialists** argue that behavior is ethical if it is motivated by a sense of duty or a set of moral principles about human conduct —regardless of the consequences of the action.

- **Consequentialist Accounts of Ethical Behavior**

Philosophers who adopt the consequentialist approach (sometimes also referred to as utilitarianism) consider that behavior can be judged ethical if it has been enacted in order to maximize human happiness and minimize harm. Jeremy Bentham (1748–1832) and John Stuart Mill (1806–73) are two of the best-known early proponents of this view. Importantly it is the common good, not personal happiness, that is the arbiter of right and wrong. Indeed, we are required to sacrifice our personal happiness if doing so enhances the total sum of happiness. For someone faced with a decision choice, the ethical action is the one that achieves the greatest good for the greatest number of people after weighing the impact on those involved. **Common criticisms of this approach are that it is impossible to measure happiness adequately, and that it essentially condones injustice, if this is to the benefit of the majority.**

- **Nonconsequentialist Accounts of Ethical Behavior**

Philosophers who adopt a nonconsequentialist approach (also referred to as deontological theory) argue that behavior can be judged as ethical if it is based on a sense of duty and carried out in accordance with defined principles. Immanuel Kant (1724–1804), for example, articulated the principle of *respect for persons*, which states that people should never be treated as a means to an end, but always as an end in themselves, leading to the easy to remember maxim – do as you would be done by. The idea here is that we can establish moral judgments that are true because they can be based on the unique human ability to reason. **One common criticism of this approach is that it is impossible to agree on the basic ethical principles of duty or their relative weighting, in order to direct choices when multiple ethical principles are called into question at the same time, or when decisions cut across cultures with different ethical principles.**

Why Behaving Ethically Is Important for Business:

Choosing to be ethical can involve short-term disadvantages for a corporation. Yet in the long term it is clear that behaving ethically is the key to sustainable development.

When you're faced with an ethical dilemma in which the immoral choice looks appealing, ask yourself three questions:

- **What will happen when (not if) the action is discovered?**
Increasingly, the behavior of corporations is under scrutiny from their various stakeholders—customers, suppliers, stockholders, employees, competitors, regulators, environmental groups, and the general public. People are less willing to keep quiet when they feel an injustice has been done, and the internet and other media give them the means to make their concerns very public, reaching a global audience. Corporations that behave unethically are unlikely to get away with it, and the impact when they are discovered can be catastrophic. This leads to the second question.
- **Is the decision really in the long-term interests of the corporation?**
Many financial services companies in the United Kingdom generated short-term profits in the 1990s by miss selling personal pensions to people who would have been better off staying in their company's pension plan. However, in the long term these companies have suffered by having to repay this money and pay penalties. Most significantly, the practice has eroded public confidence. The same is true of many banks and mortgage brokers in the first part of the 21st century, when they sold mortgages to individuals who could not afford to repay their debts. The eventual result was that large numbers defaulted, causing a meltdown in the global financial system beginning in 2008.
- **Will organizations that behave unethically attract the employees they need?**
Corporations that harm society or the environment are actually harming their own employees, including those who are making the decisions. For example, corporations that pour toxins into the air are polluting the air their employees' families breathe. Ultimately, a business relies on its human resources. If a company cannot attract high-quality people because it has a poor public image based on previous unethical behavior, it will certainly flounder.

Behaving ethically is clearly key to the long-term sustainability of any business. Focusing on the triple bottom line—the social and environmental as well as the economic impact of a company—provides the basis for sound stakeholder relationships that can sustain a business into the future”.

(Sue Newell, QFINANCE (www.qfinance.com), “Business Ethics”.)

4. Making Sound Ethical Decisions – A Checklist

“While the two approaches to evaluating behavior described above are clearly different (*i.e. Consequentialists and Nonconsequentialists*), they can be integrated to create a checklist that will help an individual or group make sound ethical decisions.

- Gather the facts:** What is the problem, and what are the potential solutions?
- Define the ethical issues.** This is a step that is often neglected, so that the ethical dilemmas raised by a particular decision are never even considered.

- ☑ **Identify the various stakeholders involved.**
- ☑ **Think through the consequences of each solution:** What happiness or harm will be caused?
- ☑ **Identify the obligations and rights of those potentially affected:** What is my duty here? Can I uphold my duty to avoid doing harm and make reasonable efforts toward that end?
- ☑ **Check your gut feeling.**

The last step is crucial. Those involved need to ask themselves what they would feel like if friends or family found out they had been involved in making a particular corporate decision, whether personally or collectively”.

(Sue Newell, QFINANCE (www.qfinance.com), “Business Ethics”.)

5. The 10-Step Method of Ethically-based Decision-making

- Short Version (last updated: August 17, 2009) – **APPENDIX A**
 - Detailed Worksheet Version (last updated: March 22, 2010) – **APPENDIX B**
- [Both versions - used by the express permission of the authors, Jon Pekel and Doug Wallace]***

6. Class Exercises: “Making the Right Decision – Ethical Dilemmas in the Workplace”

- Three business ethical dilemma scenarios (exercises) presented:
 - Identify the ethical dilemma for each scenario
 - Make one of several choices as to how to deal with the dilemma
- Each CIRM participant completes the 3 exercises on his/her own
- Then, participants placed into groups to complete the exercise again
- Compare the decisions of the individual to those of his/her group for each of the three scenarios
 - To what extent is the individual decision the same as/different from the groups? i.e. What is the effect of collaboration, if any?
- Finally, compare the decisions of the groups:
 - To what extent are they the same/different?

7. Corporate Social Responsibility (CSR)

According to the IC9900 Certification, there are four (4) key areas of corporate social responsibility. *[Note: The IC9900 Certification is the highest level of certification issued by the International Charter.]*

The four main areas assessed are:

- **Social Responsibility**
 - Community Relations -

- The company should have a formal policy and operation towards community relations
- Impact on local communities -
 - The impact on the local community and areas in close proximity to a company's operation should be continually monitored.
- Participate in local community in a positive manner -
 - Companies are encouraged to participate in local communities, encouraging their employees to volunteer for local schemes as well as sponsoring local events.
- Management of Human Rights issues in the supply chain forms part of/should form part of the company's commitment to Social Responsibility and as such is an integral part of the sourcing process. Minimum requirements expected from suppliers on their commitment to Human Rights should be included in all contracts.

Some large shareholders are motivated to promote CSR because of its capacity to enhance the company's reputation and survival.

- **Environmental Responsibility**

- Limit impact on the environment -
 - The Company must ensure that any impact on the local environment of its operations are fully assessed and action taken to limit such impact, where possible.
- Energy awareness -
 - The Company must make efforts towards reduction of energy consumption and carbon emissions.

- **Corporate Ethics**

IC9900 companies demonstrate a clear understanding of the importance of ethical conduct, encouraging employees to participate in this and having internal measures and systems to ensure consistency.

- Encourage the highest standards of ethical conduct among its employees -
 - The Company must show integrity when recruiting new staff.
- Recruit and retain staff in accordance with ethical standards.
- Meet the requirements of the Fair Pay scheme -
 - Pay a reasonable wage
 - Protect the rights of employees, whether permanent or contract.

- Provide a safe and secure environment for employees to work -
 - ☑ Environments should be free from external threats and dangers, other than those generally accepted by process.
 - ☑ Environment should be free from internal threats and harassment by other members of staff -
 - ☐ A clear process must exist for staff to raise grievances; this process must be enforced and disciplinary action supported by any findings.
- Comply with local employment laws.
- Comply with International Charter HR best practice policies.
- **Leadership Values and Integrity**
 - Companies are encouraged to develop leadership essentials, and begin a program of work with employees to ensure these qualities are found at all levels of the organization.
 - The company should undertake an annual leadership survey, polling staff on their opinions and suggestions; based on this feedback, a leadership strategy should be developed.
 - The company's leaders must indicate a clear direction with viable strategy.
 - They must not abuse market dominance and not create false barriers to entry.
 - End of year reports, such as financial reports, must be validated by both the Chief Executive Officer and Chief Financial Officer. In their absence, approval must be sought from the Board of Directors.

(Ethical Corporate Governance – Why Does It Matter? © International Charter 1997-2010

<http://www.icharter.org/certification/ic9900/>

8. The Legal Vs. Ethical Debate

Every decision that can be made falls into one of the following categories:

- Legal and Ethical

- Legal but not Ethical

- Not Legal, but Ethical

- Neither Legal nor Ethical



“Then we carefully disguise the bribes as legal fees by changing the word ‘bribes’ to ‘legal fees.’”

Corporate Governance -Duties of Board and management



“Apparently many companies experience problems including: a lack of direction, poor accountability, lack of respect among members, pushing personal agendas, poor communication ...”

Corporate Governance practice has changed notably following the recent banking crisis (2007-8). Both theory and practice in this field have changed considerably in the last 25 years. The first set of studies focused on the values and personalities of executives to which they influenced upper echelon's behavior. By 1998-2000 the same study was seen in terms of corporate governance, the core research question however remained the same: ***how does a small group of people run a large company?*** The approach raises questions on the behavior of the persons, how action is interpreted and shaped and lastly to pay attention to time and 'context' which provides the setting for interpretation of behavior.

The context in which directors work is fundamentally different from 1987 due to the significant political, social, technological and regulatory changes. This has impacted boards on how they work and what is expected of them, not just by those closet to them, but also stakeholders, regulators, the media, employees, customers, suppliers and other stakeholders. By focusing on people and behavior it has also impacted on what they expect of themselves and others.

In context boards have been performing more in the corporate/economic than the social environmental. Reference is made to significant events such as the coming down of the Berlin Wall in 1989, (redrawing of state boundaries), Twin Towers in New York (terrorist attack which impacted global travel, organizational security and risk evaluation). These global changes have impacted boards and how they function (Wright et al 2013).

In the UK the economic change which impacted boards began in 1984 with the deregulation of financial markets by Prime Minister Margaret Thatcher which saw the development of new markets- the economy was perky. This was followed in 1990 by a downturn due to corporate failures:

Barings Bank (UK)

Asil Nadir/Polly Peck International (UK)

Maxwell/Mirror Group pension scandals (UK)

Certain regulatory agencies/bodies decided to examine the auditing of UK companies which resulted after several iterations to the first UK Combined Code of Corporate Practice (1998). This marked a turning point in corporate practice and laid the foundations for the inordinate work on corporate regulation and guidance which has followed.

Between 1998-2000 there was another economic downturn which led to the crash in dot.com stocks due to its overvaluation.

Other corporate disasters were:

Long-Term Capital Management hedge fund (UK)

Equitable Life (UK)

Marconi (UK)

WorldCom (USA)*

Enron (USA)*

* These two scandals brought down Anderson (auditing firm) and led to the Sarbanes Oxley Act (2002) which had a major impact on financial reporting in global companies.

Following the collapse of the dot.com bubble the UK went into a recession, the UK had the Smith Review (2003) and Higgs Review (2003). The former on the audit practice and the latter on the role and effectiveness of non-executive directors. Over the years additional guidances were developed which impacted boards, management and governance, for example:

UK Corporate Governance Code (2010) formerly the Combined Code

FRC Guidance on Board Effectiveness an update of Higgs Review (2011)

The Stewardship Code (2010) – relates to investor behavior

Research has found that the common practice is to utilize a ‘tick-box’ approach rather than the spirit of the Code. Therefore in 2006 the UK passed a new Companies Act which includes the definition of seven (7) principles of director behaviour.

In summary the seven (7) principles are as follows:-

- (1) act in the interest of the company
- (2) act with the company’s powers
- (3) promote the success of the company
- (4) exercise independent judgment
- (5) has a duty of skill, care and diligence
- (6) must avoid conflicts of interest
- (7) must not accept benefits from third parties

No differentiation was made between executive and non-executive directors.

Besides the economic and political changes corporate governance is also impacted by corporate ownership changes. Institutional investment behavior has changed. Investors have different goals, time scales, and evaluation criteria as well as styles and patterns of engagement (Wright et al, 2013). Institutional investment has changed over the years moving more into private equity and hedge fund holdings being held by overseas investors. Between 2009-2011 the UK went through one of its biggest global economic downturns since the 1930 which was triggered by the collapse of Northern Rock plc. (2007) and Lehman Brothers investment (2008) (Wright et al 2013). The consequences of these collapses continue to be reflected in the tightening of UK regulations. However many CEOs have seen their share price go down while announcing improved corporate results will attest, interpreting corporate performance still depends on human judgment of (an) other human beings in which the way they appear to interrelate can have a strong effect (Wright et al 2013).

Technology changes has also impacted governance and the way in which boards carry out their role. Businesses depend entirely on electronic equipment moving to a

paperless environment through the use of software on Ipads to read Board documents. This changing landscape has a significant effect on directors conduct as it has changed the way they communicate with each other, the availability of obtaining and reviewing board documents in a timely manner. Even the concept of share ownership has changed with technology with companies moving away from paper share certificates.

In the financial sector the G20/OECD Principles of Corporate Governance help policy makers evaluate and improve the legal, regulatory, and institutional framework for corporate governance, with a view to supporting economic efficiency, sustainable growth and financial stability. These Principles have become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. They have also been adopted as one of the Financial Stability Board's Key Standards for Sound Financial Systems and form the basis for the World Bank Reports on the Observance of Standards and Codes (ROSC) in the area of corporate governance.

The Principle states that 'the purpose of corporate governance is to help build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies.'

The Principles focus on publicly traded companies, both financial and non-financial. But they are also a useful tool in privately owned companies.

Definition of Corporate Governance

The first version of the UK Corporate Governance Code (the Code) was published in 1992 by the Cadbury Committee. It defined corporate governance as '***the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.***' This remains true today, but the environment in which companies, their shareholders and wider stakeholders operate continues to develop rapidly.

OECD/G20 Principles of Corporate Governance defines 'corporate governance' as follows:

“Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. “

Part VI of the Principles set out the responsibilities of the Board of Directors stating that ***“The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.”***



Responsibilities of the Board

The board is mainly responsible for its corporate strategy, monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation. To effectively fulfil their responsibilities board members must be able to exercise objective and independent judgment. Another important board responsibility is to oversee the risk management system and systems designed to ensure that the corporation conforms applicable laws, including tax, competition, labour, environmental, equal opportunity, health and safety laws. In some countries, companies have found it useful to explicitly articulate the responsibilities that the board assumes and those for which management is accountable

The board also has a duty to act in the best interest of the company and its shareholders. Additionally, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities. Observance of environmental and social standards is relevant in this circumstance.

The guiding principles the board are as follows:

A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

This principle states the two key elements of the fiduciary duty of board members: the duty of care and the duty of loyalty. The duty of care requires board members to act on a fully informed basis, in good faith, with due diligence and care. In some jurisdictions there is a standard of reference which is the behaviour that a reasonably prudent person would exercise in similar circumstances. The principle calls for board members to act on a fully informed basis. Good practice takes this to mean that they should be satisfied that key corporate information and compliance systems are fundamentally sound and underpin the key monitoring role of the board advocated by the Principles.

The duty of loyalty is of central importance, since it underpins effective implementation of other principles in this document relating to, for example, the equitable treatment of shareholders, monitoring of related party transactions and the establishment of remuneration policy for key executives and board members. It is also a key principle for board members who are working within the structure of a group of companies: even though a company might be controlled by another enterprise, the duty of loyalty for a board member relates to the company and all its shareholders and not to the controlling company of the group

B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

It is an important feature of the board's work that board members when they assume their responsibilities carry out their duties in an even-handed manner with respect to all shareholders. This principle is particularly important to establish in the presence of controlling shareholders that *de facto* may be able to select all board members.

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

The board has a key role in setting the ethical tone of a company, not only by its own actions, but also in appointing and overseeing key executives and consequently the management in general. High ethical standards are in the long term interests of the company as a means to make it credible and trustworthy, not only in day-to-day operations but also with respect to longer term commitments. To make the objectives of the board clear and operational, many companies have found it useful to develop codes of conduct and to communicate them throughout the organisation. At a minimum, the ethical code should set clear limits on the pursuit of private interests, including dealings in the shares of the company. An overall framework for ethical conduct goes beyond compliance with the law, which should always be a fundamental requirement.

D. The board should fulfil certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk management policies and procedures, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

The board should have oversight of the company's risk management. This will involve oversight of the accountabilities and responsibilities for managing risks, specifying the types and degree of risk that a company is willing to accept in pursuit of its goals, and how it will manage the risks it creates through its operations and relationships. It is a crucial guideline for management that must manage risks to meet the company's desired risk profile.

2. Monitoring the effectiveness of the company's governance practices and making changes as needed.

Monitoring of governance by the board also includes continuous review of the internal structure of the company to ensure that there are clear lines of accountability for management throughout the organisation. In some jurisdictions self-assessment by boards of their performance as well as performance reviews of individual board members and the Chair and the CEO.

3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning

4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

It is a good practice for boards to develop and disclose a remuneration policy statement covering board members and key executives. Such policy statements specify the

relationship between remuneration and performance, and include measurable standards that emphasize the longer run interests of the company over short term considerations. They also often specify terms to be observed by board members and key executives about holding and trading the stock of the company, and the procedures to be followed in granting and re-pricing of options. In some countries, policy also covers the payments to be made when hiring and/or terminating the contract of an executive.

In large companies, it is considered good practice that remuneration policy and contracts for board members and key executives be handled by a special committee of the board comprising either wholly or a majority of independent directors and excluding executives that serve on each other's remuneration committees, which could lead to conflicts of interest. The introduction of malus and claw-back provisions is considered good practice.

5. Ensuring a formal and transparent board nomination and election process.

Shareholders have an active role in the nomination and election of board members.

1. While actual procedures for nomination may differ among countries, the board or a nomination committee has a special responsibility to make sure that established procedures are transparent and respected.

2. The board has a key role in defining the general or individual profile of board members that the company may need at any given time, considering the appropriate knowledge, competencies and expertise to complement the existing skills of the board.

3. The board or nomination committee has the responsibility to identify potential candidates to meet desired profiles and propose them to shareholders, and/or consider those candidates advanced by shareholders with the right to make nominations.

6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

It is an important function of the board to oversee the internal control systems covering financial reporting and the use of corporate assets and to guard against abusive related party transactions. These functions are often assigned to the internal auditor which should maintain direct access to the board. It is important for the board to encourage the reporting of unethical/unlawful behaviour without fear of retribution. The existence of a company code of ethics should aid this process which should be underpinned by legal protection for the individuals concerned.

7. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

The Board should demonstrate a leadership role to ensure that an effective means of risk oversight is in place. Ensuring the integrity of the essential reporting and monitoring systems will require the board to set and enforce clear lines of responsibility and accountability throughout the organisation. The board will also need to ensure that there is appropriate oversight by senior management. The internal audit function should report to an independent audit committee of the Board and who is also responsible for managing the external audit thereby allowing a co-ordinated response by the board. The board should retain final responsibility for oversight of the company's risk management system and for ensuring the integrity of the reporting systems. Some jurisdictions have provided for the chair of the board to report on the internal control process.

8. Overseeing the process of disclosure and communications

The functions and responsibilities of the board and management with respect to disclosure and communication need to be clearly established by the board.

E. The board should be able to exercise objective independent judgement on corporate affairs.

In order to exercise its duties of monitoring managerial performance, preventing conflicts of interest and balancing competing demands on the corporation, it is essential that the board is able to exercise objective judgement. This will mean independence and objectivity with respect to management with important implications for the composition and structure of the board.

The variety of board structures, ownership patterns and practices in different countries will thus require different approaches to the issue of board objectivity. In many instances objectivity requires that a sufficient number of board members not be employed by the company or its affiliates and not be closely related to the company or its management through significant economic, family or other ties. This does not prevent shareholders from being board members.

Independent board members can contribute significantly to the decision-making of the board. They can bring an objective view to the evaluation of the performance of the board and management. In addition, they can play an important role in areas where the interests of management, the company and its shareholders may diverge such as executive remuneration, succession planning, changes of corporate control, take-over defences, large acquisitions and the audit function. In order for them to play this key role, it is desirable that boards declare who they consider to be independent and the criterion for this judgement. Some jurisdictions also require separate meetings of independent directors on a periodic basis.

1. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.

Independent non executive board members can provide additional assurance to market participants that their interests are safeguarded. The board should consider establishing specific committees to consider questions where there is a potential for conflict of interest. These committees should require a minimum number or be composed entirely of non-executive members. In some countries, shareholders have

direct responsibility for nominating and electing non-executive directors to specialised functions.

2. Boards should consider setting up specialised committees to support the full board in performing its functions, particularly in respect to audit, and, depending upon the company's size and risk profile, also in respect to risk management and remuneration. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.

Based on the size of the company and its board, the use of committees may improve the work of the board. Where boards establish independent audit committees with powers to oversee the relationship with the external auditor and to act in many cases independently. Audit committees should also be able to oversee the effectiveness and integrity of the internal control system. Other such committees include those dealing with nomination, compensation, and risk.

3. Board members should be able to commit themselves effectively to their responsibilities.

Service on too many boards can interfere with the performance of board members. Some countries have limited the number of board positions that can be held. Specific limitations may be less important than ensuring that members of the board enjoy legitimacy and confidence in the eyes of shareholders. Disclosure about other board memberships to shareholders is therefore a key instrument to improve board nominations.

4. Boards should regularly carry out evaluations to appraise their performance and assess whether they possess the right mix of background and competences.

In order to improve board practices and the performance of its members, an increasing number of jurisdictions now encourage companies to engage in board training and voluntary board evaluation that meet the needs of the individual company. Particularly

in large companies, board evaluation can be supported by external facilitators to increase objectivity. Unless certain qualifications are required, such as for financial institutions, this might include that board members acquire appropriate skills upon appointment. Thereafter, board members may remain abreast of relevant new laws, regulations, and changing commercial and other risks through in-house training and external courses. In order to avoid groupthink and bring a diversity of thought to board discussion, boards should also consider if they collectively possess the right mix of background and competences.

F. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information

Board members require relevant information on a timely basis in order to support their decision-making. Non-executive board members do not typically have the same access to information as key managers within the company. The contributions of non-executive board members to the company can be enhanced by providing access to certain key managers within the company such as, for example, the company secretary, the internal auditor, and the head of risk management or chief risk officer, and recourse to independent external advice at the expense of the company. In order to fulfil their responsibilities, board members should ensure that they obtain accurate, relevant and timely information. Where companies rely on complex risk management models, board members should be made aware of the possible shortcomings of such models.

G. When employee representation on the board is mandated, mechanisms should be developed to facilitate access to information and training for employee representatives, so that this representation is exercised effectively and best contributes to the enhancement of board skills, information and independence.

Employee representation on boards should be applied in a way that maximises its contribution to the board's independence, competence and information. Employee representatives should have the same duties and responsibilities as all other board members, and should act in the best interest of the company. Procedures should be established to facilitate access to information, training and expertise, and the independence of employee board members from the CEO and management.

Corporate Governance Initiatives: USA Response

- **Sarbanes-Oxley Act (SOX), 2002 only applies to companies whose stock is traded on the public exchange.**

The Sarbanes-Oxley Act of 2002 was passed to regain public confidence in the stock market following a string of major accounting fraud cases involving public companies. A plan to accomplish this objective is outlined in 11 titles, which:

- Prohibit conflicts of interest
- increase corporate accountability
- increase accounting transparency
- form an oversight board to enforce the new rules



“With swine flu, we need to get the message across to the public that there is no need to panic.”

Corporate Governance Initiatives: Bahamas Response [See APPENDIX G]

- **Central Bank of the Bahamas (CBOB) – Guidelines (Dec. 2001, with May 8, 2013):**
 - ❖ Corporate Governance Framework (Section 4)
 - ❖ Responsibility of the Board (Sections 5)
 - ❖ Operations of the Board including establishment of committees (Section 6)
 - ❖ **Management** (Section 4 subsections 4.5 and 4.7)

Senior management is responsible for the day-to-day operations of the business, serving as a link between the Board and staff. The senior management is responsible for:

- a. Implementing the licensee’s strategic plan;
- b. Keeping the Board adequately informed about the performance of the licensee through financial and management reports and the reports prepared by internal auditors, external auditors, the compliance officer and regulators;
- c. Advising the Board on the appropriate organisational structure, and ensuring that the quantity and quality of staff resources are available to carry out all tasks, including internal audit and compliance;
- d. Implementing and maintaining risk management systems appropriate to the scale, nature and complexity of the licensee;
- e. Delineating and documenting the areas of responsibility for each staff member, and ensuring that reporting lines are clear and appropriate, in the context of the scale, nature and complexity of the licensee;

❖ **Duties of the Board** (Section 10)

10.1 All directors of a licensee have a duty to perform their functions with diligence and care and with such degree of competence as can reasonably be expected from persons with their knowledge and experience.

10.2 All directors of a licensee have a duty to ensure that the risks that are of necessity undertaken by the licensee in the conduct of its business are managed in a prudent manner.

10.3 All directors of a licensee have a duty to require that management provide them with adequate, appropriate and substantive information on the activities and operations of the licensee.

10.4 All directors of a licensee have a duty to independently assess and question the policies, processes and procedures of the licensee, with the intent to identify and initiate management action on issues requiring improvement.

10.5 All directors of a licensee should have a basic knowledge and understanding of the conduct of the business of the licensee and the laws, regulations, guidelines, other regulatory requirements, and the customs and practices that govern that business. Although not every director is expected to be fully conversant with every aspect of the business of the licensee, the competence of every director should be commensurate with the nature and scale of the overall business. Directors should work to acquire the knowledge and skills necessary to perform their functions on assigned specialized committees of the Board effectively, if such committees are used.

10.6 All directors, in exercising any authorities of a director or discharging any of their duties as a director should:

- a. act with honesty, integrity and good faith with the view to the best interests of the licensee and its clients;
- b. exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances;
- c. exercise independent judgment in their approach to decision-making and problem-solving;
- d. act on a fully-informed basis;
- e. understand and devote sufficient time to their responsibilities;
- f. act only within the scope of their authority; and
- g. recognise and guard against conflicts of interest in dealing with the licensee, taking into account the interests of all stakeholders

Executive and Non-executive Directors

In the case of *Jaques v AIG Australia Ltd* [2014] VSC 269 (13 June 2014) Justice Dixon explained the difference between executive and non executive directors:

“The essential characteristic of an executive director is his or her discharge, usually as an employee, of executive functions in the management and administration of the company. Non-executive directors are usually independent of corporate management. In contemporary corporate governance theory, the role of independent, non-executive directors is encouraged. The opportunity to offer indemnity against risk arising from wrongful managerial acts to persons outside of a company who agree to act as its directors has sound commercial advantages for a company. There are sound commercial advantages for the insurer as this policy was clearly intended to attract potential policy holders who seek to provide such cover in order to more readily attract appropriate persons to act as non-executive directors. The directors rely on management to manage the corporation. The board does not expect to be informed of the details of how the corporation is managed.”



Judge Dixon then set out the functions for which directors relied on management and continued:

Another division of function is between the non-executive directors and the chief executive officer or managing director. Generally a chief executive is a director to whom the board of directors has delegated its powers of management of the corporation's business. Usually the chief executive is employed under a contract of service which will either include an express term or, in the absence of an express term, an implied term, that the chief executive will exercise the care and skill to be expected of a person in that position. The degree of skill required of an executive director is measured objectively. In contrast to the managing director, non-executive directors are not bound to give continuous attention to the affairs of the corporation. Their duties are of an intermittent nature to be performed at periodic board meetings, and at meetings of any committee of the board upon which the director happens to be placed. Notwithstanding a small number of professional company directors there is no objective standard of the reasonably competent company director to which they may aspire.

It is well accepted that the office of managing director, the classic executive director, has powers of day to day management of a company that are exercisable without reference to the board as a delegated executive management function. In contrast, appointment as a director, other than as managing director, carries no express or implied grant of executive power. The position of director does not carry with it any ostensible authority to act on behalf of the company. Directors can only act collectively as a board and the function of an individual director is to participate in decisions of the board. It is a question of fact whether a person has assumed the powers of a managing director, or, I would add, an executive director, with the approval of the company.

The term 'non-executive director' in the policy refers to a person who is a director of the insured entity and who is not an executive director. A managing director is, absent special circumstances, as a matter of law an executive director. Whether a director, other than the managing director, is an executive director is a question of fact. It may depend on whether there is some feature of the company's constitution, or conduct of the company in general meeting or of the board of directors that evidences the delegation of executive function, in the sense that I have described, to that director to operate as an executive of the company.

The Role of Independent Non-Executive Directors (Central Bank of The Bahamas, Corporate Governance Guidelines, Section 7)

INEDs are intended to provide checks and balances to ensure that licensees operate in a safe and sound manner and that the interests of the institution are protected. It is considered sound practice for licensees to consider direct reporting of the internal audit function to the Board through an audit committee or other structure comprising a majority of independent members. It may be beneficial for INEDs to meet in the absence of bank management at least annually with the external auditor and the heads of the internal audit, compliance and legal functions. This can strengthen the ability of a bank's Board to oversee management's implementation of the Board's policies and to ensure that a licensee's business strategies and risk exposures are consistent with risk parameters.

7.2 A Board should regularly re-evaluate the mix of skills that it needs to be effective and be willing and able to change its composition accordingly over time. Therefore, rigorous reviews should be undertaken before INEDs who have served for a period of six years or more are considered for reappointment or re-election, as the case may be.

7.3 All directors, including INEDs are encouraged to make contact with the Central Bank via the Inspector, to discuss matters of mutual concern. Further, upon resigning from the board, all directors, including INEDs are encouraged to inform the Central Bank and provide an explanation for the decision, either by way of written correspondence or in person, by scheduling a meeting with the Inspector.

In summary, a director needs to exhibit skilled behavior, but the nature of what is considered skilled has changed over time (Wright et al, 2013). Two relationships stand out as critical in providing the alliance to board and management performance:

(1) The relationship between CEO and chairman which effect significantly on board practice and process which is also important in terms of management expectations and conduct.

(2) The relationship between CEO and finance director.

In the late 1980s the position of CEO and chairman was combined and even when separated the chairman still acted as the CEO, however, twenty years ago the chairman acted as an advisor and monitor to the CEO. The CEO became more of a focal point in the media. Ten years ago, the CEO and chairman were seen as partners with frequent conversations and both being in the media holding deep respect and trust in each other. It can be said that the relationship between CEO and chairman has influenced the board process and performance.

With regard to the NED, over thirty years ago, they were very few of them and they added no value to the board. Following the regulatory change in 1998, when the role of chairman and CEO were separated, companies were required to appoint NED who were independent. In some jurisdictions boards were required to have more NEDs than Executive Directors. It is expected that the board will challenge the information submitted by management and act as a team. It is expected that the members of the board to respect for each other and their judgment.

Even though there are regulatory differences across jurisdictions as to the expectations of NED and Executive Directors, be reminded that in law, there is only one category of director.

Notwithstanding that there is a difference between full time executive appointment (with operational responsibility and authority) and a part-time NED (Wright et al 2013). Presently there has been a shift with less Executive Directors on the board with the NED relying more on the CEO and Finance Director for updates on operational matters.



Shareholders (AGM)

Shareholders' Independent Auditors

Board of Directors

Board Nomination Committee

Compliance Committee

Corporate Governance Committee

Audit Committee

H. R. & Management
Compensation/Remuneration
Committee

Business Risk Review Committee

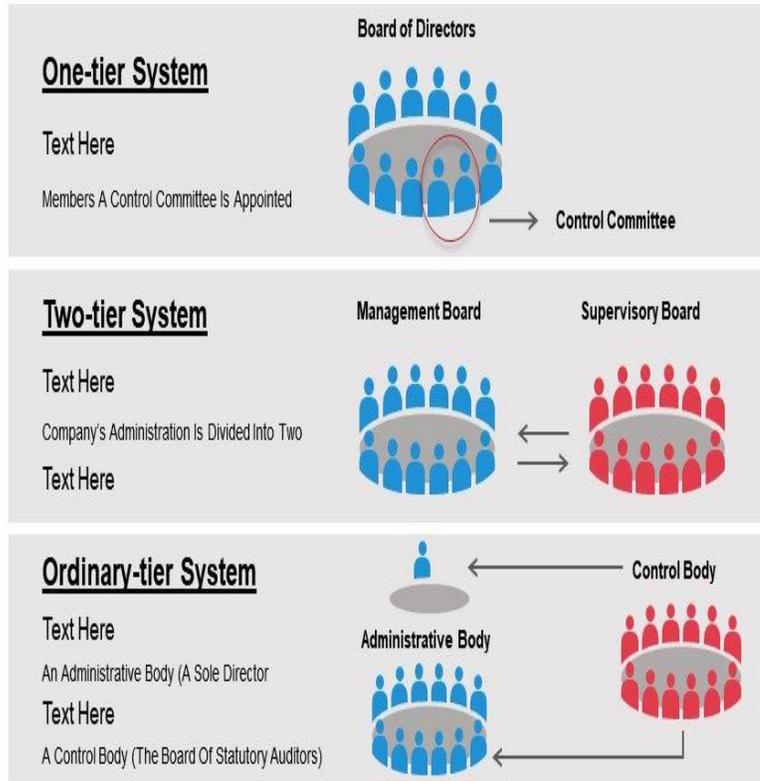
**Executive
Committee/Officers**

Management Team



3 Models Of Corporate Governance PPT Layout

The Three Models



This slide is 100% editable. Adapt it to your needs and capture your audience's attention.

Relations with Shareholders and other Stakeholders

There has been renewed interest in corporate governance since the collapse of Enron and other companies which precipitated regulatory changes. One of the compelling forms of corporate governance is company ownership.

Shareholders differ in their motivation, risk propensities, and time horizons which add complexity for managers. The increase in institutional investors has changed the manager-owner relationship representing more than 70% of corporate stocks (Wright et al 2013). The collective goals of these shareholders supercede those of other shareholders as executives focus on their desires to make changes in the company.

It is noted that the form of ownership affect managerial decision-making and corporate strategy. Equity owned by insiders represents an ‘alignment’ approach to corporate governance, where self-interest by management can be mitigated by allowing the agents to be principals so that by working toward their own interests they are also meeting the interests of other shareholders (Dalton et al., 2003)

Equity owned by outsiders represents a ‘control’ approach to governance. This approach emphasizes outside owners’ motivation to check on managers to ensure that stakeholder interests are consistently being met and that equity owners receive the highest possible profits (Dalton et al., 2003).

Outsiders may be:

‘**blockholders**’ either a single corporation or individual people or ‘government’ referred to as state ownership or sovereign wealth funds.

‘**institutional investors**’: referring to different types of funds: Pension funds, professional investment management funds, insurance companies, banks, trust companies, mutual funds, foundations and brokerages houses.

‘**venture capital/private equity**’: referring to a new company which needs funding. Wealthy individuals or partnerships (‘angel investors’) that hold informal ties to new companies and are chosen by the founders because of their ability to contribute knowledge or expertise, established social network and most certainly their high networth.

The ability and interest of institutional investors and asset managers to engage in corporate governance varies widely. For some investors, engagement in corporate governance, including the exercise of voting rights, is a natural part of their business model for other investors it is through voting, which may be ineffective.

CS249216



“Thank you gentlemen for voting me as chairman.”

It is recommended that institutional investors disclose their policies with respect to corporate governance. Shareholder engagement can be voting at shareholder meetings. Another form of engagement by shareholder is to have direct contact and dialogue with the board and management.

The G20/OECD Corporate Governance Principles are as follows:

A. Institutional investors acting in a fiduciary capacity should disclose their corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.

For institutional investors the effectiveness of the corporate governance framework depends on their willingness and ability to make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest. This means that the institutional investors should disclose how they exercise their ownership rights with due consideration to cost effectiveness. For institutions acting in a fiduciary capacity, such as pension funds, collective investment schemes and some activities of insurance companies, and asset managers acting on their behalf, the right to vote can be considered part of the value of the investment being undertaken on behalf of their clients. Failure to exercise their ownership rights could result in a loss to the investor who should therefore be made aware of the policy to be followed by the institutional investors.

Disclosure of corporate governance policies include the following:

- (i) explicit strategies regarding the circumstances in which the institution will intervene in a company;
- (ii) the approach they will use for such intervention; and

- (iii) how they will assess the effectiveness of the strategy.
- (iv) Disclosure of actual voting records, either to their clients (only with respect to the securities of each client) or, in the case of investment advisors to registered investment companies, to the market.
- (v) Develop a continuing dialogue between the institutional investor and the company such as background information about the markets.
- (vi) Secure appropriate human and financial resources to pursue the implementation of the policy in a way that the beneficiaries and portfolio companies can expect.

B. Votes should be cast by custodians or nominees in line with the directions of the beneficial owner of the shares.

Custodian institutions holding securities as nominees for customers should not be permitted to cast the votes on those securities unless they have received specific instructions to do so. Rules should require custodian institutions to provide shareholders with timely information concerning their options in the exercise of their voting rights. Shareholders may elect to vote by themselves or to delegate all voting rights to custodians or shareholders may just wish to be informed of shareholder meetings.

C. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.

Where there is a conflict of interest between the intermediary to vote their shares and exercise key ownership functions which differs from those of direct owners. Such conflicts should be identified and disclosed especially if the conflict arise from material business relationship.

D. The corporate governance framework should require that proxy advisors, analysts, brokers, rating agencies and others that provide analysis or advice relevant to decisions by investors, disclose and minimise conflicts of interest that might compromise the integrity of their analysis or advice.

Providers of proxy advisory services should, where appropriate in each context, disclose publicly and/or to investor clients the process and methodology that underpin their recommendations, and the criteria for their voting policies relevant for their clients. In some jurisdictions self-regulatory codes to mitigate such conflicts of interest or other risks related to integrity, and have provided for private and/or public monitoring arrangements.

E. Insider trading and market manipulation should be prohibited and the applicable rules enforced.

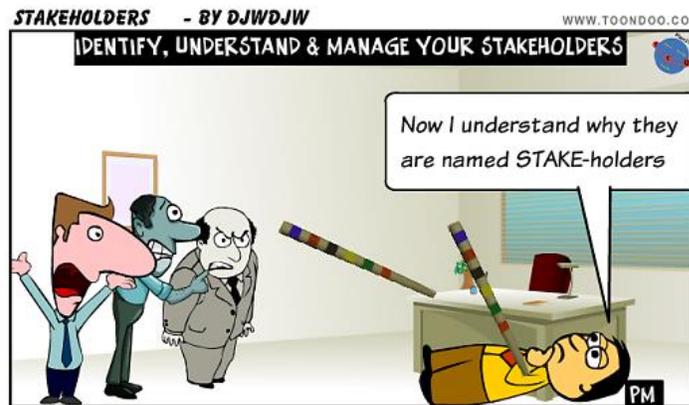
These practices can be seen as constituting a breach of good corporate governance as they violate the principle of equitable treatment of shareholders. However, the effectiveness of such prohibition depends on vigorous enforcement action.

F. For companies who are listed in a jurisdiction other than their jurisdiction of incorporation, the applicable corporate governance laws and regulations should be clearly disclosed. In the case of cross listings, the criteria and procedure for recognising the listing requirements of the primary listing should be transparent and documented.

The company should therefore clearly disclose which jurisdiction's rules are applicable. When key corporate governance provisions fall under another jurisdiction than the jurisdiction of trading, the main differences should be noted.

G. Stock markets should provide fair and efficient price discovery as a means to help promote effective corporate governance.

Effective corporate governance means that shareholders should be able to monitor and assess their corporate investments by comparing market related information with the company's information about its prospects and performance. When shareholders believe it is advantageous, they can either use their voice to influence corporate behaviour, sell their shares (or buy additional shares), or re-evaluate a company's shares in their portfolios. The quality of and access to market information including fair and efficient price discovery regarding their investments is therefore important for shareholders to exercise their rights.



The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

It is in the long-term interest of corporations to foster wealth-creating co-operation among stakeholders. The governance framework should recognise the interests of stakeholders and their contribution to the long-term success of the corporation. The competitiveness and ultimate success of a corporation is the result of teamwork that embodies

contributions from a range of different resource providers including investors, employees, creditors, customers and suppliers, and other stakeholders.

A. The rights of stakeholders that are established by law or through mutual agreements are to be respected.

The rights of stakeholders are often established by law (e.g. labour, business, commercial, environmental, and insolvency laws) or by contractual relations that companies must respect. Even where stakeholder interests are not legislated, many firms make additional commitments to stakeholders, and concern over corporate reputation and corporate performance often requires the recognition of broader interests.

B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

C. Mechanisms for employee participation should be permitted to develop.

The degree to which employees participate in corporate governance depends on national laws and practices, and may vary from company to company as well. In the context of corporate governance, mechanisms for participation may benefit companies directly as well as indirectly through the readiness by employees to invest in firm specific skills.

D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.

E. Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and to the competent public authorities and their rights should not be compromised for doing this.

Unethical and illegal practices by corporate officers may not only violate the rights of stakeholders but also be to the detriment of the company and its shareholders in terms of reputation effects and an increasing risk of future financial liabilities. It is therefore to the company's advantage and its shareholders to establish procedures and safe-harbours for complaints by employees, either personally or through their representative bodies, and others outside the company, concerning illegal and unethical behaviour. The board should be encouraged by laws and or principles to protect these individuals and representative bodies by utilizing the following options:

- giving stakeholders confidential direct access to someone independent on the board, often a member of an audit or an ethics committee;and
- establishing an ombudsman to deal with complaints;

Other examples are:

- confidential phone and e-mail facilities established by regulators to receive allegations

In the absence of timely remedial action or in the face of reasonable risk of negative employment action to a complaint regarding contravention of the law, employees are encouraged to report their bona fide complaint to the competent authorities. The company should refrain from discriminatory or disciplinary actions against such employees or bodies.

F. The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

Creditors are a key stakeholder and the terms, volume and type of credit extended to firms will depend importantly on their rights and on their enforceability. Companies with a good corporate governance record are often able to borrow larger sums and on more favourable terms than those with poor records or which operate in less transparent markets.

The framework for corporate insolvency varies widely across countries. In some countries, when companies are nearing insolvency, the legislative framework imposes a duty on directors to act in the interests of creditors, who might therefore play a prominent role in the governance of the company. Other countries have mechanisms which encourage the debtor to reveal timely information about the company's difficulties so that a consensual solution can be found between the debtor and its creditors.

Creditor rights also vary, ranging from secured bond holders to unsecured creditors. Insolvency procedures usually require efficient mechanisms for reconciling the interests of different classes of creditors. In many jurisdictions provision is made for special rights such as through "debtor in possession" financing which provides incentives/protection for new funds made available to the enterprise in bankruptcy.



"Our main goal is to please our stakeholders... except when their processes are complex... or when they have too many requirements... or when they are hard to deal with."

Financial Disclosure and Non Financial Disclosures

A strategy that all countries deploy to improve shareholder protection is to provide investors with more transparency. In most countries there have been dramatic changes in transparency standards. Hence the requirement for more strict disclosure regulation which will likely affect corporate governance system as it reduces the private benefits of control to major blockholders but it also helps investors to monitor the management better (Wright et al, 2013).

At a minimum, public disclosure is typically required on an annual basis though some countries require periodic disclosure on a semi-annual or quarterly basis, or even more frequently in the case of material developments affecting the company. Companies often make voluntary disclosure that goes beyond minimum disclosure requirements in response to market demand.

Disclosure requirements are not expected to place unreasonable administrative or cost burdens on enterprises. Nor are companies expected to disclose information that may endanger their competitive position unless disclosure is necessary to fully inform the investment decision and to avoid misleading the investor. The decision as to what should be disclosed is based on 'materiality'. Material information can be defined as information whose omission or misstatement could influence the economic decisions taken by users of information or information that a reasonable investor would consider important in making an investment or voting decision.

Disclosure can also be a powerful tool for influencing the behaviour of companies and for protecting investors. A strong disclosure regime can help to attract capital and maintain confidence in the capital markets. By contrast, weak disclosure and non-transparent practices can contribute to unethical behaviour and to a loss of market integrity at great cost, not just to the company and its shareholders but also to the economy as a whole. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting of shares. Insufficient or unclear information may hamper the ability of the markets to function, increase the cost of capital and result in a poor allocation of resources.

Disclosure also helps improve public understanding of the structure and activities of enterprises, corporate policies and performance with respect to environmental and ethical standards, and companies' relationships with the communities in which they operate.

The G20/OECD Corporate Governance Principles – Disclosures and Transparency

A. Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company

Investors are interested in information that may cast light on the future performance of the company. Audited financial statements showing the financial performance and the financial situation of the company (most typically including the balance sheet, the profit and loss statement, the cash flow statement and notes to the financial statements) are the most widely used source of information on companies. They enable appropriate monitoring to take place and also help to value securities. Management's discussion and analysis of operations is typically included in annual reports.

2. Company objectives and non-financial information

Companies are encouraged to disclose policies and performance relating to business ethics, the environment and, where material to the company, social issues, human rights and other public policy commitments. Such information may be important for certain investors and other users of information to better evaluate the relationship between companies and the communities in which they operate and the steps that companies have taken to implement their objectives.

3. Major share ownership, including beneficial owners, and voting rights.

One of the basic rights of investors is to be informed about the ownership structure of the company and their rights vis-à-vis the rights of other owners. The right to such information should also extend to information about the structure of a group of companies and intra-group relations. Such disclosures should make transparent the objectives, nature and structure of the group.

Disclosure of ownership data should be provided once certain thresholds of ownership are passed. Such disclosure might include:

- data on major shareholders and others that, directly or indirectly, significantly influence or control or may significantly influence or control the company through, for example, special voting rights, shareholder agreements,
- the ownership of controlling or large blocks of shares, significant cross shareholding relationships and cross guarantees.

It is also good practice to disclose shareholdings of directors, including non-executives. Information about the beneficial owners should be obtainable by regulatory and enforcement agencies and/or through the judicial process.

4. Remuneration of members of the board and key executives.

Companies are generally expected to disclose information on the remuneration of board members and key executives so that investors can assess the costs and benefits of remuneration plans and the contribution of incentive schemes, such as stock option schemes, to company performance.

5. Information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board

For board members, the information should include their qualifications, share ownership in the company, membership of other boards, other executive positions, and whether they are considered by the board to be an independent member. It is important to disclose membership of other boards not only because it is an indication of experience and possible time pressures facing a member of the board, but also because it may reveal potential conflicts of interest and makes transparent the degree to which there are interlocking boards.

There is also the requirement to have independent directors on the board with some jurisdictions requiring a majority of its directors to be independent. The Board should set out the reasons why a director is independent.

6. Related party transactions.

To ensure that the company is being run with due regard to the interests of all its investors, it is essential to fully disclose all material related party transactions and the terms of such transactions to the market individually. Related parties should at least include entities that control or are under common control with the company, significant shareholders including members of their families and key management personnel. Related parties should be properly identified and that in cases where specific interests of related parties are present, material transactions with consolidated subsidiaries are also disclosed.

7. Foreseeable risk factors.

Users of financial information and market participants need information on reasonably foreseeable material risks that may include: risks that are specific to the industry or the geographical areas in which the company operates; dependence on commodities; financial market risks including interest rate or currency risk; risk related to derivatives and off-balance sheet transactions; business conduct risks; and risks related to the environment.

Disclosure of risk is most effective when it is tailored to the particular company and industry in question. Disclosure about the system for monitoring and managing risk is increasingly regarded as good practice.

8. Issues regarding employees and other stakeholders.

Companies are encouraged, and in some countries even obliged, to provide information on key issues relevant to employees and other stakeholders that may materially affect the performance of the company or that may have significant impacts upon them.

Disclosure may include:

- management/employee relations, including remuneration, collective bargaining coverage, and mechanisms for employee representation, and
- relations with other stakeholders such as creditors, suppliers, and local communities.
- human resource policies, such as programmes for human resource development and training, retention rates of employees and employee share ownership plans, can communicate important information on the competitive strengths of companies to market participants.

9. Governance structures and policies, including the content of any corporate governance code or policy and the process by which it is implemented.

Disclosure of the governance structures and policies of the company, including, in the case of non-operating holding companies, that of significant subsidiaries, is important for the assessment of a company's governance and should cover the division of authority between shareholders, management and board members.

It is also good practice to disclose the articles of association, board charters and, where applicable, committee structures and charters.

B. Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial reporting.

This disclosure standard is meant to improve the ability of investors to monitor the company by providing increased relevance, reliability and comparability of reporting, and improved insight into company performance. Most countries mandate the use of internationally recognised standards for financial reporting, which can serve to improve transparency and the comparability of financial statements and other financial reporting between countries.

C. An annual audit should be conducted by an independent, competent and qualified, auditor in accordance with high-quality auditing standards in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

In addition to certifying that the financial statements represent fairly the financial position of a company, the audit statement should also include an opinion on the way in which financial statements have been prepared and presented. This should contribute to an improved control environment in the company. In some jurisdictions, the external auditors are also required to report on the company's corporate governance.

It is good practice for external auditors to be recommended by an independent audit committee of the board or an equivalent body and to be appointed either by that committee/body or by shareholders directly.

The IOSCO Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence states that, "*standards of auditor independence should establish a framework of principles, supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures, that addresses at least the following threats to independence: self-interest, self-review, advocacy, familiarity and intimidation*".

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

It also underlines that the external auditor owes a duty of due professional care to the company rather than any individual or group of corporate managers that they may interact with for the purpose of their work.

E. Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.

Filing of statutory reports has been greatly enhanced in some countries by electronic filing and data retrieval systems. Company websites also provide the opportunity for improving information dissemination, and some countries now require companies to have a website that provides relevant and significant information about the company itself.

1. Case Study

“Reputation Risk & Corporate Governance: A Bahamian Scenario – What Would You Do?”

Written by Glen R. Nottage. © 2013. All rights reserved.

Disclaimer: The following is a totally fictitious story. While set in the Bahamas, it is completely made up for classroom discussion only. It has no basis in fact, either related to any person(s), living or dead, or event(s), whether current or past.

Profile:

Mr. Alfred M. Bishus, is the CEO of Breezy Shore Financial Co. Ltd., located in Nassau, Bahamas. He migrated to the Bahamas from the USA in 1969, and obtained permanent residency in 1978. He is the brother of a sitting USA politician, who is the ranking member and Chairman of the House Ways and Means Committee. He is married to a born-Bahamian, who is the niece of a former Governor General. Her aunt is a sitting Justice of the Bahamas Supreme Court. Mr. and Mrs. Bishus reside on Paradise Island. They have two adult children, both are senior partners in their respective world-renowned accounting firms. The son resides in the USA and the daughter resides in Canada.

Mr. A. M. Bishus has worn many hats. He is a former boy scout leader, has sat on various Government Boards since 1973 through successive governments, is an Associate Minister in his Baptist Church, a Grand Master in his lodge, and a Past Area Governor of Rotary. He currently sits on the advisory board for the Salvation Army and the Ranfurly Homes for Children. Additionally, he is extremely well-liked by the Bahamian public, as he was very instrumental in granting loans to persons who would not ordinarily qualify for them when he was a branch manager. Further, he rushes with one of the major Junkanoo groups (of which he and the bank are sponsors).

Mrs. Bishus is a housewife, and currently sits as the Chair of the Bahamas Red Cross Committee.

Case Scenario:

Breezy Shore Financial Co. Ltd. is a publicly traded subsidiary company on BLSX, with 20% of its common shares owned by various Bahamian individuals or companies. The remaining 80% is owned by the parent company located in the U.K. The parent company is desirous of selling 5% of its shareholdings to another foreign financial institution, based in Switzerland, but has not publicized the pending sale. Due to the current economic environment, the Swiss investor (i.e. financial institution) has requested that a forensic audit be conducted. The acquisition by the Swiss investor has the potential to boost the share price of Breezy Shore by 53% at least. Once the acquisition occurs, it is expected

that Breezy Shore would conduct a 3-for-1 stock split. As a result of the audit, some fraudulent activity has been uncovered involving Mr. A. M. Bishus, the CEO.

The CEO gave himself multi-million dollar loans to facilitate the construction of two sets of condominium complexes on Paradise Island, as well as loans to facilitate investment capital into several well-established businesses. The complexes were put in company names. One of the businesses invested in is owned by a former PLP Parliamentarian (whose brother is a sitting PLP Senator), and another is owned by a former senior FNM Parliamentarian.

Additionally, he arranged to purchase a large block of shares from current Bahamian shareholders who have been financially struggling since the economic downturn.

Mr. A. M. Bishus was able to conduct the above activities with the assistance of his CFO, Mr. Michael Dorightin, his V. P. Lending, Mr. Jason Gonehome, and the Corporate Secretary, Ms. Thelma Itover.

Mr. Dorightin was brought into the bank by Mr. Bishus, firstly as Finance Manager, at a time when he (Dorightin) had lost his job at another financial institution due to redundancy.

Ms. Itover is the Godmother of Mr. Bishus' son, and a long-time friend of Mrs. Bishus. Staff are unaware of the relationship.

Mr. Gonehome is Mrs. Bishus' nephew (her sister's son). He came to Nassau from Eleuthera at the age of 13 in order to attend St. Andrew's High School, and lived with another aunt. Mr. and Mrs. Bishus paid for his high school tuition as well as for his college education, up to the Master's level. This relationship is also unknown to staff.

The Board of Directors is aware of the above three connections/relationships.

Proposed Action:

- What are the implications for the institution?
- What are the implications for the various stakeholders?
- What are the international implications, if any?
- What action(s) should the board take, if any?
 - Examine the various options and the pros and cons for each
 - Justify your decision(s)

List of Appendices

Appendix A – Deloitte Global Survey on Reputation Risk
(https://www2.deloitte.com/content/dam/Deloitte/za/Documents/risk/NEWReputationRiskSurveyReport_25FEB.pdf)

Appendix B – Deloitte Reputation Risk Matters -Developing reputational resilience ahead of your crisis, June 2016
(<https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/risk/deloitte-uk-reputation-matters-june-2016.pdf>)

Appendix C - *The Financial Crisis: Reform and Exit Strategies.*

OECD 2009, Summary of Main Themes – Reform Principles (Pages 9, 10 and 51)

Appendix D - *The Ten Step Method of Ethically-based Decision-Making (Short Version).*

Jon Pekel & Doug Wallace, August 17, 2009

Appendix E - *The Ten Step Method of Ethically-based Decision-Making (Detailed Version).*

Jon Pekel & Doug Wallace, March 22, 2010

Appendix F – *G20/OECD Principles of Corporate Governance.*

OECD 2015

Appendix G - *Basle Committee on Banking Supervision Guidelines -Corporate Governance Principles for Banks, July 2015-*

A

Appendix H - *Enhancing Corporate Governance for Banking Organisations.*

Basel Committee on Banking Supervision, February 2006 (Pages 6 – 18)

Appendix I - *Guidelines for the Corporate Governance of Banks and Trust Companies Licensed to do Business Within and From Within The Bahamas, May 8, 2013*

Appendix J – *Securities Commission of The Bahamas - Securities Industry Corporate Governance Rules, 2019 and amendment*

The Oxford Handbook of Corporate Governance, Mike Wright, Donald S. Siegel, Kevin Keasey and Igor Filatotchev, Oxford University Press, 2013

Gallup Poll (<https://news.gallup.com/poll/1597/confidence-institutions.aspx>)