



There's more to Risk Governance than just Risk

**Sub-saharan Africa
Basel 2/3 Design and Implementation Insights**

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Forward

Welcome to this paper focused on the Risk Governance Framework and how it relates to the Financial Services Industry

The global financial crisis exposed the fact that many banks lacked a proper understanding of their true risk profile. A comprehensive risk appetite framework is the cornerstone of an effective risk management architecture. Therefore, financial institutions are to put in place an effective risk management system, by translating risk metrics and methods into strategic decisions, reporting, and day-to-day business decisions. In this paper, KPMG will be leveraging its experience on Basel 2/3 Discipline and Implementation Insights in Sub-Saharan Africa services to banks to discuss practical challenges in risk governance and provide insightful solutions in responding to these challenges.

At its simplest, risk appetite can be defined as the amount of risk, on a broad level, that an organization is willing to take on in pursuit of value. In other words, it is the total impact of risk an organization is prepared to accept in pursuit of its strategic objectives. Risk appetite vary from organization to organization and can also vary across business units and risk types. For example, a bank's appetite for risk in mature lending activities may be quite different from its appetite for risk in an emerging business. Organizations use different ways to measure risk appetite. Risk governance involves a clear risk appetite statement that is approved by the board and embodied in the risk policy and delegated authorities. This sets the 'tone from the top' and a foundation for the risk culture.

The International Institute of Finance (IIF) 2009 defined 'risk culture' as the "norms and traditions of behavior of individuals and of groups within an organization that determine the way in which they identify, understand, discuss, and act on the risks the organization confronts and the risks it takes". A firm's culture is based not only on overt rules and regulations but also on shared assumptions. The importance of risk culture can never be underestimated. Most major contemporary examples of organizational fraud and financial failure over the past 20 years were related to instances of flawed or ambiguous risk cultures. Risk culture can be positively changed and improved organically with strong efforts from

management. From a regulatory perspective, this means that, in order to ensure that risks are being managed properly, firms need to understand their existing culture and make meaningful efforts to change the culture to properly address risks embedded in it. To reinforce risk culture, the organization's risk appetite should be integrated into the performance management framework at the individual level to ensure consistent application.

For the purpose of risk appetite, risk limits are quantitative measures based on forward looking assumptions that allocate the total risk appetite statement of a financial institution to business lines, risk categories, concentrations and other appropriate levels. Recurring breaches of risk limits could cause the bank's risk profile to materially exceed its risk appetite. Therefore, risk limits should be effectively monitored and reported. Risk limits should be specific, measurable, frequency-based and based on forward looking assumptions. Risk limits help to prevent a financial institution from unknowingly exceeding its risk capacity and taking excessive risks. Risk limits are set by considering the interaction between risks within and across business lines and their impact on the financial institution's exposures and outcomes by stress testing at the granular and industry wide levels. Limits should be set at levels that prompt the board and management to manage risk proactively before the bank's risk profile jeopardizes Bank's risk levers of profitability, concentration, capital and reputation.

To make risk appetite a more valuable element of risk management, an improved combination of risk appetite and timely monitoring of the company's actual risk profile against risk tolerances are necessary. Business decisions made with the benefit of greater risk awareness will be better rewarding in avoiding unnecessary risks.

We hope you enjoy reading this paper and that it provides useful insights on risk governance particularly in the financial industry.

About This Paper

This report is developed by KPMG's network of Financial Risk management (FRM) experts. The insights are based on discussions with our member firms' clients and our professionals' assessment of key financial risk management focusing on Sub-Saharan Africa.



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Executive Summary

Effective risk governance requires five key components:

- (i) a risk appetite statement,
- (ii) delegation of authority that allows for timely and accurate decision making,
- (iii) risk limit monitoring,
- (iv) risk-return-based decision making and
- (v) risk-return-based performance evaluation.

The risk appetite statement sets the parameters within which a firm must operate. The second two components monitor employee activities to help the firm remain in compliance with its risk appetite. The last two components provide incentives for employees to make decisions that are optimal and consistent with a firm's risk appetite statement and its strategic objectives.



1. A risk appetite statement that identifies major risks and defines acceptable levels for each type of risk

Regulatory and industry practices strongly suggest firms develop a risk appetite program to guide risk governance. However, a risk appetite program is difficult to develop, challenging to embed throughout the organization and hard to demonstrate “compliance”. Risk appetite challenges can be placed into two broad categories. The first category covers governance issues related to risk appetite program oversight and processes. The second, technical issues associated with the design and implementation of the risk appetite program. Below we provide a high-level overview of the governance-related risk appetite challenges.

2. A framework that defines policies, and processes, and delegates authority to manage risk in a timely and accurate manner

Delegation of authority is critical for accurate and timely decision making. “Accuracy-centric” decisions, such as compliance with health and safety and regulatory standards, require more checks and balances, and therefore a more centralized decision-making process. Those decisions require group consensus and should not be delegated to single individuals. “Timeliness-centric” decisions, such as approving a tactical customer-pricing strategy, need to be executed swiftly to mitigate the risk of lost opportunities. Such decisions should be delegated. Business units that have more accurate ground-level information are often best suited to make these decisions. Their activities are still subject to legal entity level risk limits.

3. Risk metrics and limits that reflect regulator and shareholder interest, and measure traditional risk areas as well as risks to a firm’s strategic growth plan

Risk limits should be subdivided into tolerance zones to implement



corrective actions and be sensitive to economic changes. Each risk area identified in the risk appetite statement should be monitored via metrics that satisfy basic criteria. Risk metrics should be:

- (i) simple to calculate at the legal entity level;
- (ii) chosen from risk and performance metrics of interest to regulators and shareholders; and
- (iii) easy to communicate.

4. Risk-return-based decisions that extend to profit centers and risk management activities

Organizations should develop tools to analyze the risk and return profiles of business opportunities and internal firm activities before considering them acceptable. These internal and external opportunities must meet minimum return hurdles given their contribution to risk or must stay below maximum risk hurdles given their expected returns. All acceptable opportunities should be compared to prioritize business opportunities. This can be achieved by developing a firm-specific efficient frontier and plotting each internal and external candidate opportunity on that frontier to judge whether it can be accepted.

5. Policies that effectively link compensation to risk decision making, as well to the firm's ability to evaluate the impact of these decisions

To provide incentive for risk managers to reduce risk effectively, performance evaluations should be based on their contribution to profitability. For example, effectiveness of risk mitigation strategies could be based on returns earned on reserves released from risk mitigation. Compensation policies for senior risk officers that have fixed salaries might not be as effective, as they likely induce excess risk aversion.



Risk Appetite Statement

Harmonizing the Risk Appetite Statement and the Strategic Plan

One challenge faced by firms as they manage their risk appetite program is to harmonize risk appetite efforts with the strategic plan. Both the risk appetite and the strategic plan documents share a common objective of promoting deliberate, sustainable and controlled business growth.

Unique yet Linked Documents

The strategic plan and risk appetite statements are two distinct and yet inextricably linked documents with significant overlaps and interconnections. The strategic plan is a forward-looking document that typically covers significant firm initiatives including growth and expansion efforts, large-scale projects, hiring and human capital programs, and community involvement. The risk appetite statement is a formal articulation of the firm's willingness to accept risk, in line with its key operating principles. Despite their differences, the strategic plan and risk appetite statement share a common objective of promoting deliberate, sustainable, and controlled business growth.

Competing Risk, Finance and Business Objectives

These common objectives can create tension between the Risk, Business and Finance functions as they develop thresholds which guide or govern a similar topic. A strategic plan may lead management to generate margin and business activities considering Return on Equity (ROE) and business sector growth goals. Similarly, the risk appetite statement may guide management to develop "quality" earnings and reduce losses. While each document serves its unique mission, the combined message may be contradictory and result in unapproved or stalled business activities. It can be very difficult to find an intersection that is acceptable to all.

Striking a Balance

Many leading firms have successfully reconciled the risk appetite statement and the strategic plan, despite the inherent difficulties. There are many factors contributing to a harmonious process. First, firms should acknowledge the commonalities and potential overlaps in each document and candidly address the potential operational and political implications if

ignored. Next, the firm should establish boundaries or protocols by which each document is expected to pursue common objectives. Finally, firms should establish a formal mechanism by which to harmonize the risk appetite statement and the strategic plan prior to approval by the Board.

- **Acknowledge commonalities.** It is very important that Risk, Finance and Business collaborate closely when developing the risk appetite statement and strategic plan. Both documents should be subject to review and input from a cross-functional committee, with sufficient organizational influence to make changes to the documents where necessary.
- **Establish boundaries.** Firms should define clear parameters around common guiding principles, such as solvency, growth and profitability to prevent each document from prescribing strategy in an area that is a core responsibility of the other document.
- **Result rationalization.** Firms should create or authorize an independent subcommittee comprised of equal numbers of Business, Finance and Risk professionals to model, debate, and gain consensus, by voting if necessary, to resolve conflicting issues raised in the risk appetite and strategy documents.

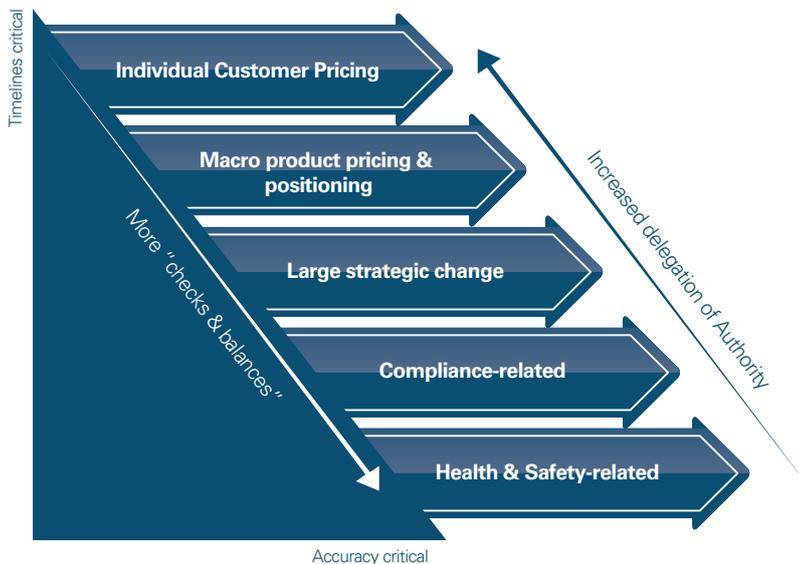


Delegation of Authority

Organizational decisions require different levels of scrutiny from a risk management perspective.

“Accuracy-centric” decisions, such as compliance with health and safety and regulatory standards, require more checks and balances, and need a more centralized decision-making process even though this can slow the process. “Timeliness-centric” decisions, such as approving a new lending opportunity or market trade, are best delegated to the business units, which have better ground-level

Figure 2: Decision-making processes should count for the “timeliness vs. accuracy” requirements of different decision types



- Different decision-types require alternative approaches relative to timing vs. accuracy
- “Accuracy-centric” decisions require more “checks and balances”
- “Timeliness-centric” decisions require increased delegation of authority

Governance frameworks must clearly specify decision-making authority along with individual escalation responsibilities and processes. These guidelines should weigh the timeliness of an activity versus the accuracy it requires.

The ability of Senior Management to delegate decision making also requires an escalation process to effectively manage atypical behavior and new business opportunities. For example, the decision process will likely differ for normal vs. outsized investments/ acquisitions, which could require a higher level of diligence and caution prior to approval. Such decisions would need to be made at a higher level to ensure compliance with risk exposure levels.

Activities that exceed set risk limits require approval from managers with independent oversight. Not all activities have pre-approved risk limits, however. For example, Business Continuity Planning must seek prior approval on any type of expenditure associated with choosing an emergency location. Emergency location choices must meet several health and safety standard constraints, and suit the needs of diverse areas within the firm. Business Continuity Planning is therefore an “Accuracy-Centric” decision and is made centrally rather than being delegated.



Risk Limits & Monitoring

A risk appetite statement must be actionable. This is achieved by translating risk appetite directives into risk limits and tolerance zones on key operating metrics, such as leverage, liquidity, growth, and income

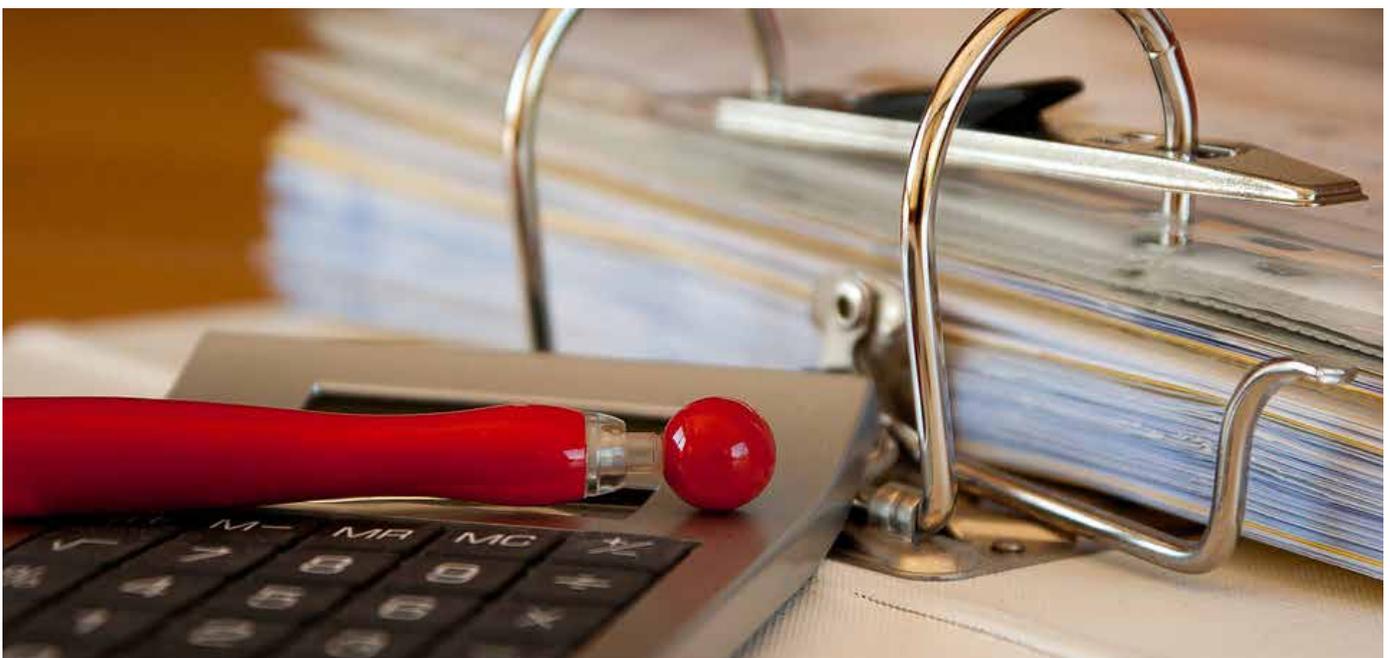
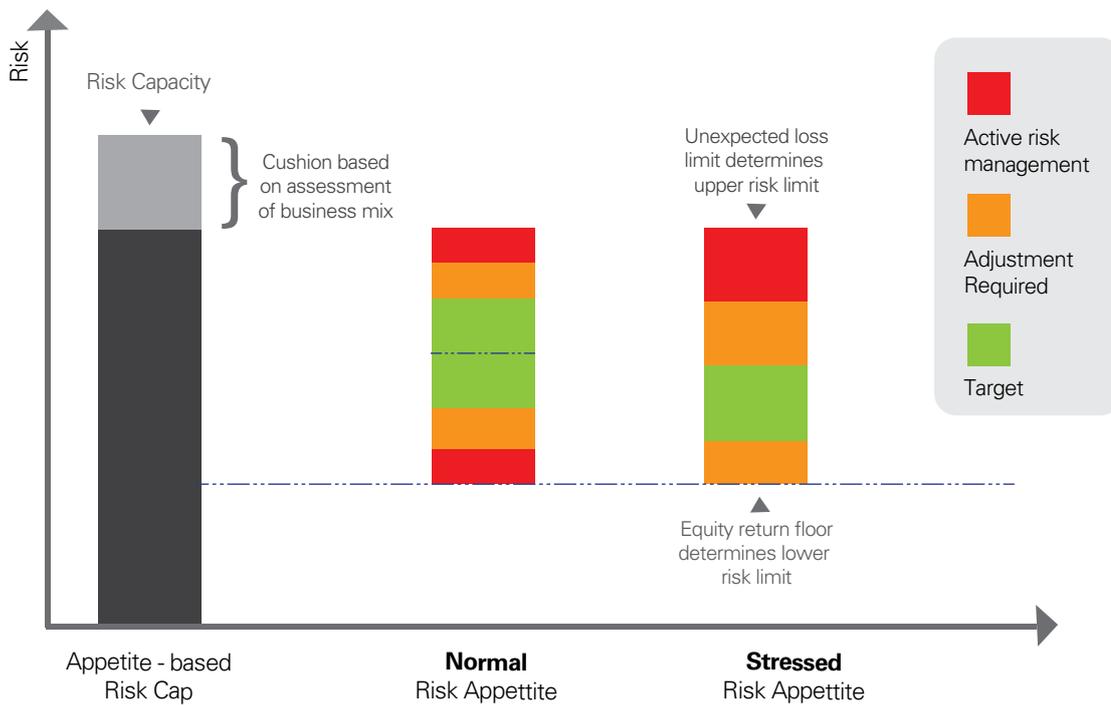
Figure 3 provides an example of risk limit setting. It shows upper and lower levels of risk consistent with the firm's equity return and unexpected loss risk appetite. Risk within these risk limits is further subdivided into Target (green), Adjustment Required (amber), and Active Risk Management (red) zones. As risk enters the amber or red zones, the firm adopts measures to return it to normal. The severity of actions varies depending on whether the firm is in a state of caution or crisis.

In the Adjustment Required zone, a firm requires business units to maintain or improve leverage for new businesses. The firm itself does not actively reduce or decrease leverage on its existing businesses. It expects risk to return to target levels over time. In the Active Risk Management zone, a firm takes active steps to return risk to normal. These actions may include equity issuance, sale of assets, or debt buybacks. These corrective actions would vary across risk measures. For example, in the case of revenue growth, corrective actions might include changes in pricing and marketing expenditures policies.

Figure 3 also shows that the firm maintains different risk limit levels and tolerance zones depending on the state of the economy. In times of stress, the market's ability to accommodate a firm's needs is likely to be lower. As such, a firm must adopt a more defensive set of risk tolerance zones than in normal times. Figure 3 shows risk tolerance zones under both normal and stressed periods. Under stress, the firm hits its amber and red zones at lower levels of risk than before. During stress, the firm is also more likely to be actively managing risk.

This is indicated by the relatively large range over which risk is considered to be in the Active Risk Management zone. The fact that risk tolerance zones and risk limits are likely to vary with the state of the economy also implies that organizations must track firm-specific metrics, as well as metrics that determine the health of the external environment.

Figure 3: Designing Risk Tolerance Bands Around Risk

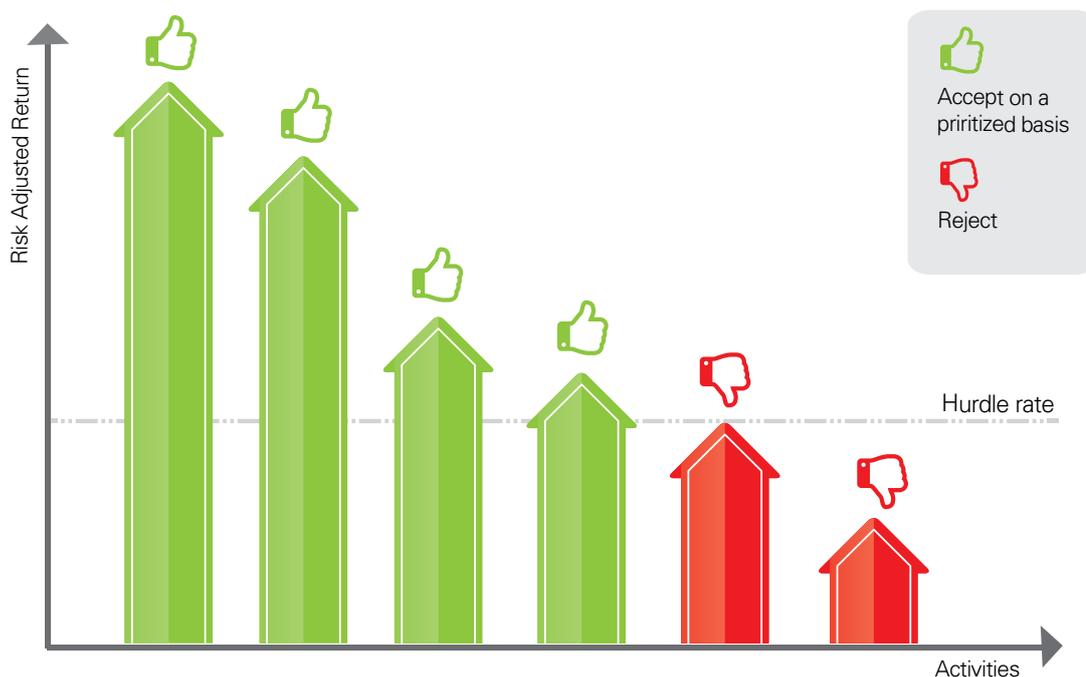


Risk-Return-Based Decision Making

For a firm to achieve its key risk objectives, these risks should be incorporated into risk-return metrics used for daily decision making. Many firms have adopted risk-adjusted return metrics for making business decisions. Examples of such metrics include Risk Adjusted Return on Capital (analysis in subsequent page), mean-variance-based metrics, such as Sharpe Ratio, or comparison of the Return on Equity (ROE) in an upside scenario to the ROE in a stressed scenario, such as an Upside-Downside ROE ratio. In addition, some firms have developed tools to view real-time risk-return metrics across business units. They have also created tools to prioritize business opportunities, ensuring that those with the best risk-adjusted returns are undertaken first.

These tools allow firms to reject internal or external activities that generate risk-adjusted returns lower than the firm's hurdle rate. Those with risk-adjusted returns greater than the firm's hurdle rate are accepted on a prioritized basis with the most profitable activities being undertaken first.

Figure 4:



RAROC* as Driver to Monitor Risk/Return Profile

Performance measurement of returns on the basis of income generated is no longer trending in leading companies as performance measurement is now based on risk-adjusted performance.

*Risk-Adjusted Return on Capital (RAROC) is an adjustment to the return on an investment that accounts for the element of risk. In the example below, bank XYZ sets a measure of how much return this investment will provide given the level of risk associated with it. This can be used to allocate resources to investments based on their associated risk.

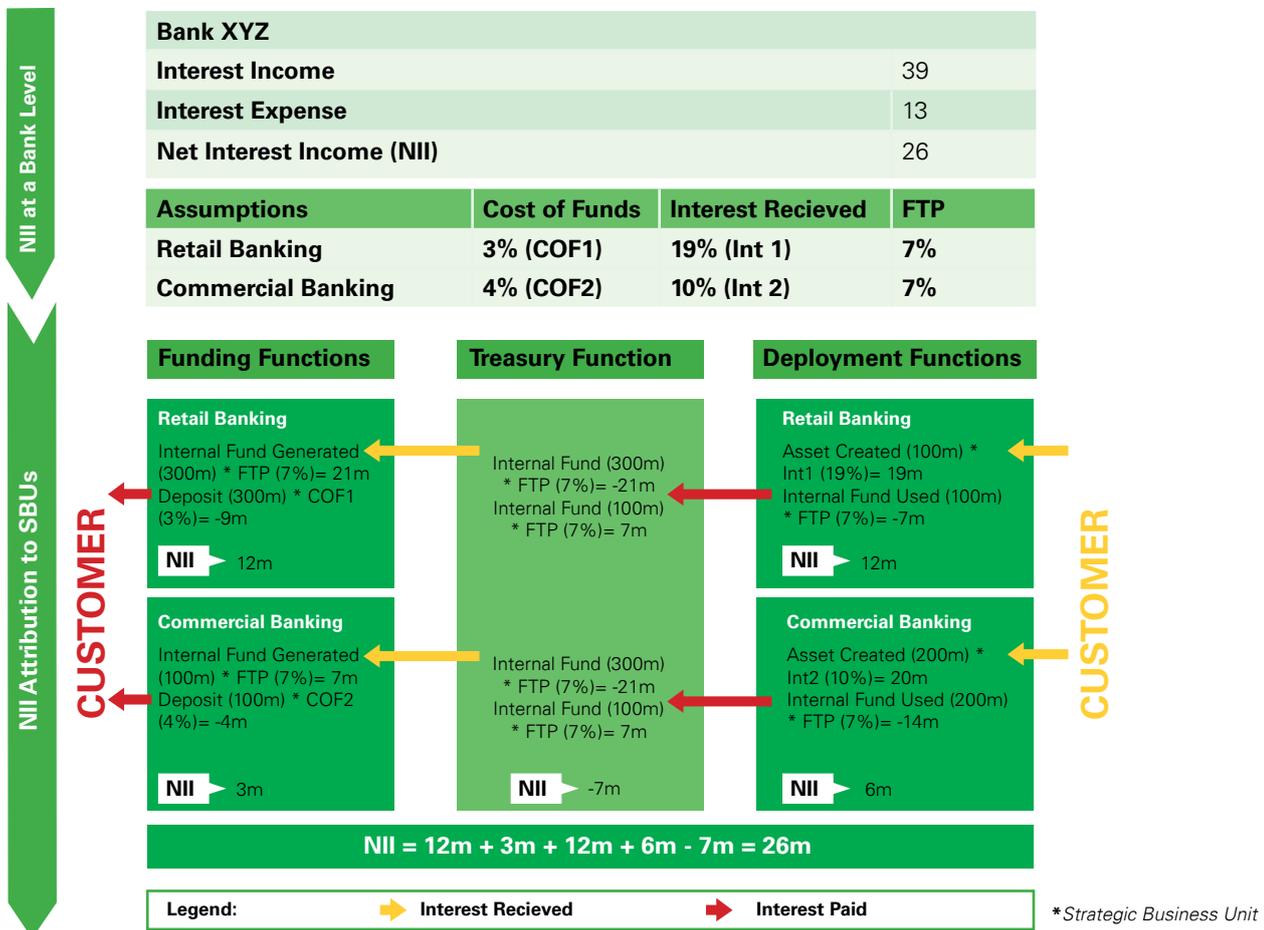
Figure 5:



Net Interest Income Attribution to SBU

The Treasury Department has a vital role in allocating funds from units with surplus to units deficient in funds. The lending unit obtains deposits from customers at an interest and lends to treasury at a higher interest, thereby making income. Treasury on the other hand lends to the borrowing unit at an even higher rate. The borrowing unit trades and makes income and pays off treasury. Net Interest Income is the difference between interest earned and interest paid, and is commonly tracked by banks and other institutions that lend money.

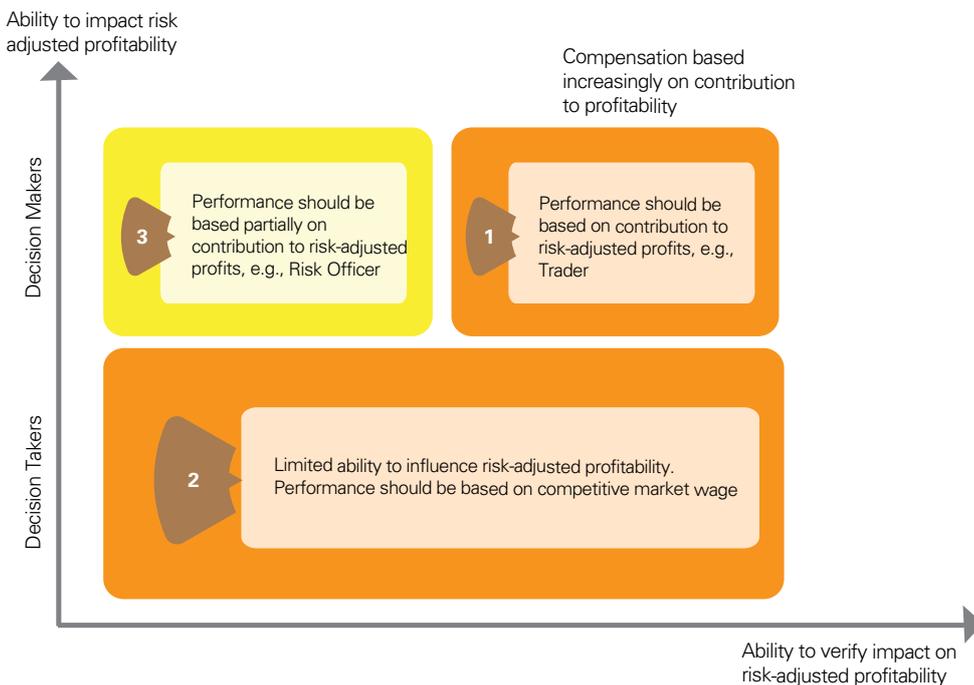
Figure 6:



Risk-Return-Based Performance Evaluation

Risk governance frameworks should formulate compensation policies that provide incentives for decision makers while keeping “decision takers” motivated. One way to design effective compensation policies is to link compensation not only to an individuals’ ability to make decisions that affect risk, but also to the firm’s ability to evaluate the impact of their decisions. Figure 6 shows how compensation policies can vary across individuals.

Individuals who are decision makers and whose actions can easily be verified (Box 1) should receive a larger proportion of their compensation in the form of firm equity or other variable compensation. Individuals who are decision takers (Box 2) should be compensated primarily at competitive market wage levels.



Individuals in Box 3 are important decision makers (e.g., Risk and Treasury Officers), but the impact of their actions on profitability can be more difficult to verify.

Such individuals generally have the ability to take actions that reduce risk and enhance risk-adjusted profitability materially. Often, however their compensation packages are fixed and not based on the impact of the actions on firm profitability. This can lead to excessive conservatism on the part of risk managers who might be reluctant to take any risk since they will not benefit from it.

Instead, compensation policies should be flexible enough to both reward and penalize risk managers for the decisions they make. For example, a Treasurer that puts on a commodity hedge to reduce oil price exposure has likely freed reserves on the firm's balance sheet. Has the firm been able to redeploy these reserves at a return level that compensates for the cost of the hedges? If so, then the Treasurer has added value to the firm, and his compensation should reflect this. By doing so, the firm provides an incentive for such individuals to proactively seek out risk-reducing strategies that are cost effective for the firm.



Conclusion

An effective risk governance framework is one in which strategic goals of the firm are laid out in the firm's strategic plan, and metrics that monitor progress against these goals are used to make daily decisions. Risk metrics reflect regulator and shareholder interest and measure traditional risk areas as well as risks to a firm's strategic growth plan. These metrics, and limits around them are specified in the firm's risk appetite statement.

The risk appetite statement and the firm's strategic plan are unique yet linked documents with areas of overlap. It is very important that Risk, Finance and Business collaborate closely when developing the risk appetite statement and strategic plan. Firms should define clear parameters around common guiding principles to prevent each document from prescribing strategy in an area that is a core responsibility of the other document. Firms should create or task an independent subcommittee comprised of equal numbers of Business, Finance and Risk professionals who can model, debate, and gain consensus, by voting if necessary around conflicting issues raised in the risk appetite and strategy documents. Compensation for decision makers is tied to these metrics and this provides incentives for them to act in the best interests of the firm. We believe current compensation structures of many managers are not tied to their contribution to performance metrics and this can lead them to be over-conservative. The firm's risk management monitors risk limits for any violations and follows mitigating action plans whenever key risk metrics begin to approach or exceed limit levels.

To ensure efficient monitoring of risks, there is a clear delegation of responsibilities. "Accuracy-centric" decisions, such as compliance with health and safety and regulatory standards, require more checks and balances, and therefore a more centralized decision-making process. "Timeliness-centric" decisions, such as approving a customer pricing strategy, are best delegated to business units that have more accurate ground-level information.

Risk limits are monitored by subdividing a limit into risk tolerance zones. As a risk enters the caution or crisis zones, the firm adopts measures to return it to normal. The severity of actions varies depending on which zone the firm is in. Risk tolerance zones vary with the economic environment the firm is in.

Risk-return based decision making allow firms to prioritise internal or external activities that generate risk-adjusted returns higher than the firm's hurdle rate and reject activities with risk-adjusted returns lower than the firm's hurdle rate. Firms should have a robust framework and build capacity for quantifying risks and embedding them in decision making. Risk-adjusted returns should be an input to performance measurement.

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