CORPORATE GOVERNANCE & RISK MANAGEMENT

July 2012

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Agenda

1 What is Corporate Governance?

2 What is Risk Management?

3 How do they intersect ?

4 Why is Risk Governance important - What is consequence of failure?

5 What to do (how do we respond?)

5 Discussion

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1

WHAT IS CORPORATE GOVERNANCE?

Corporate Governance

- What is Corporate Governance?
- There are many definitions. The CBN Code of Corporate Governance defines it as follows:
- Corporate governance refers to the processes and structures by which the business and affairs of an institution are directed and managed. In order to improve long-term shareholder value by enhancing corporate performance and accountability, while taking into account the interest of other stakeholders.
- Corporate governance is therefore about building credibility, ensuring transparency and accountability as well as maintaining an effective channel of information disclosure that would foster good corporate performance.

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Corporate Governance

- For me, it is simply:
  - Doing the right things and doing things right.

- In other words, “Doing the right things for the organization and doing things the right way independent of personal interests”

- We could say it is the Processes and Systems by which a company is governed which ensure appropriate checks and balances”.

- Essence is to ensure:
  – Good performance of the organization
  – proper accountability to all stakeholders
  – mitigation of conflicts of interest

- Stakeholders include: Customers, Staff, Shareholders, Suppliers, Regulators, Communities

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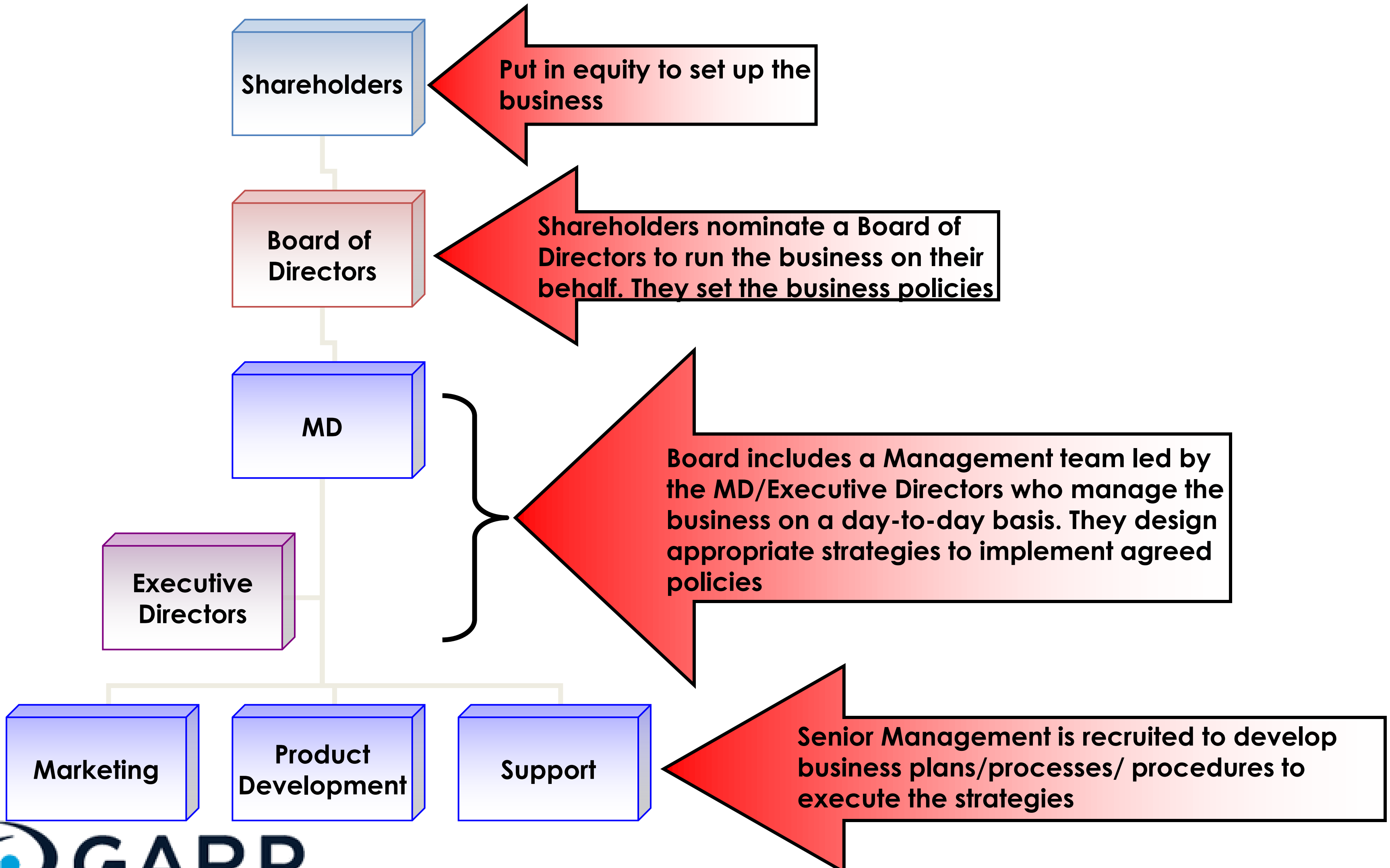
Corporate Governance



Corporate Governance

- FOUR PILLARS OF CORPORATE GOVERNANCE
  - Fairness
  - Accountability
  - Independence
  - Transparency

- Major elements of corporate governance
  - Board Commitment
  - Good board practices,
  - Functional and effective control environment,
  - Transparent disclosure,
  - Well defined shareholder rights

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WHAT IS RISK MANAGEMENT?

Risk Management

- What is Risk Management?
- **Risk management** is the identification, assessment, and prioritization of risks.
- It is defined in ISO 31000 as *the effect of uncertainty on objectives* (whether positive or negative) followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities.

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Risk Management

Key Issues

- Probability (Likelihood) of event occurring
- Severity (Impact) of the event on set objectives
- The strategies to manage risk typically include transferring the risk to another party, avoiding the risk, reducing the negative effect or probability of the risk, or even accepting some or all of the potential or actual consequences of a particular risk.
- Let's look at common risks in financial institutions

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Risk Management

- Credit Risk - *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.

- Market Risk - Market risk refers to the risk of loss to an institution resulting from movements in market prices, in particular, changes in interest rates, foreign exchange rates, and equity and commodity prices.

- Operational Risk – This is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

The drivers of Credit Losses

Probability of Default (PD)

Will an asset become a defaulted asset?

Loss Given Default (LGD)

What proportion of the value of a defaulted asset will we lose?

Exposure At Default (EAD)

What is the expected value of the defaulted asset at the time of default?

Maturity

The effective remaining term of a facility.

- Unexpected Losses

There are many other risk types

PILLAR 1 RISKS	PII: OTHER RISKS	APPLICATION
CREDIT RISK	LIQUIDITY RISK	STRESS TESTS
	RESIDUAL RISK	SCENARIO ANALYSES
	SECURITISATION RISK	Supervisory Review Evaluation Process (SREP)
	CONCENTRATION RISK	
OPERATIONAL RISK	INTEREST RATE RISK	
	REPUTATION RISK	
	BUSINESS RISK	
	TRANSFER RISK	PLANNING
MARKET RISK	INSURANCE RISK	
	STRATEGIC RISK	ICAAP
	OTHER RISKS	

- Business strategy, processes and existing exposure drive risk exposure.
- Risk exposure set according to risk appetite requires need for capital as a buffer for unexpected losses
- Pillar 1 ‘standardised’ capital requirement for market, credit and operational risk elements
- PII risks measured through internal economic capital framework
- Supervisory process monitor capital adequacy

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HOW DO THEY INTERSECT?

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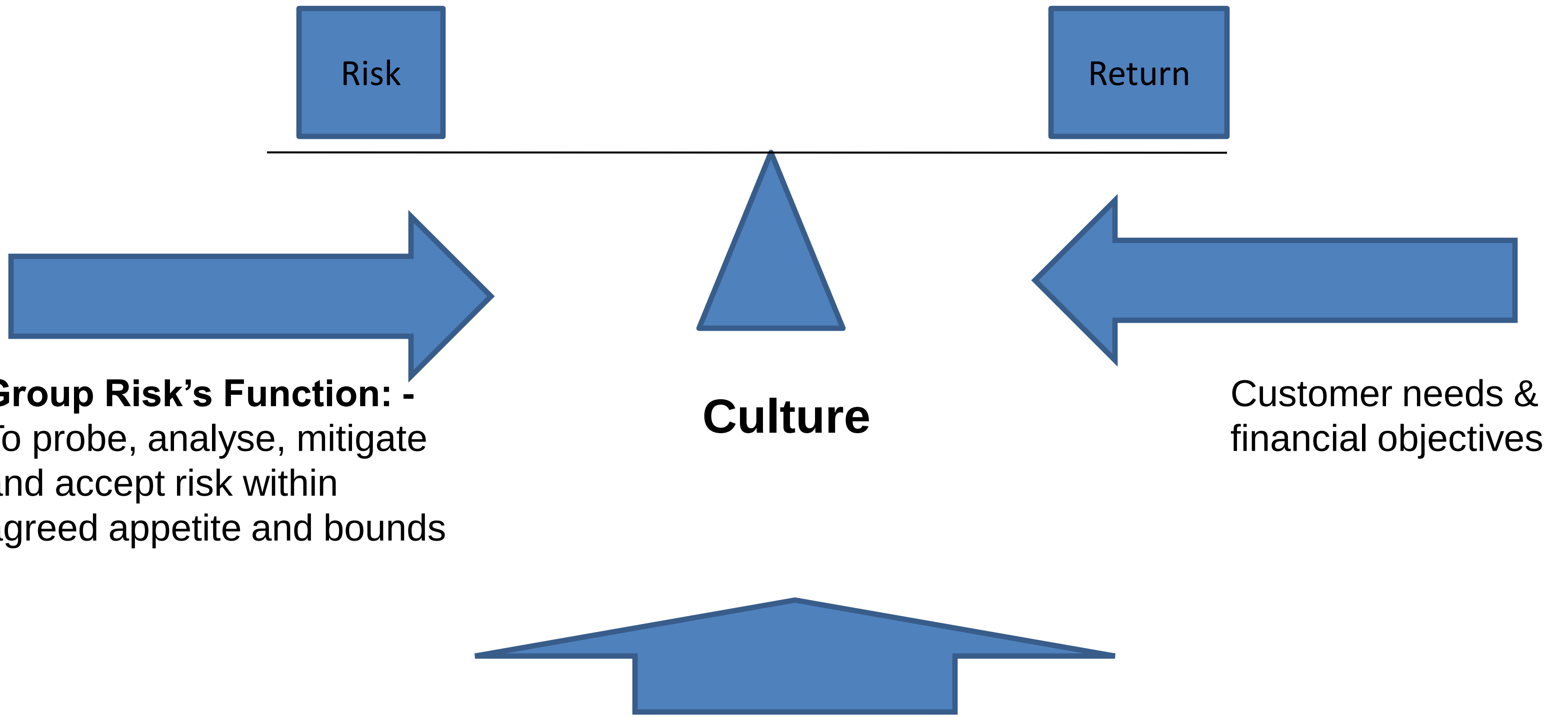
Risk Culture: A Question of Balance

Company must focus on achieving growth and profitability within appropriate risk/control boundaries



Corporate Governance: Monitoring & effective controls, using a macro view of the institution built around a shared cultural approach

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WHAT HAPPENS WHEN THERE IS A FAILURE?

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What happens when it fails?

- Consequences can be dire…
- From reputation risk; job losses; company collapse; etc
- Few case studies are as follows:

Recent Banking Crises

Selected Banking Crises: Non-Performing Loans and Costs of Restructuring Financial Sector

	Year	Duration (year)	Non-performing Loan (% of total loan)[a]	Bank Credit/GDP%[b]	Fiscal and Quasi-fiscal Costs/GDP[c]	Output loss (% of GDP)	Currency Crisis as well (pre-fix**)
High Income							
Japan	1992-98	7.0	35.0	119.5	8.0 (17)		No
Korea	1997-		30-40	70.3	34.0	50.1	Yes**
United State	1984-91	8.0	4.0	42.7	3.2[d]		No
Argentina	1980-82	3.0	9.0	29.8	55.3	10.8	Yes**
Argentina	1995	1.0	n/a	19.7	1.6	7.1	No
Argentina	2001		20.1		9.6	42.7	
Bulgaria	1996		75.0		14.0	1.3	
Egypt	1980				n/a	38.1	
Ghana	1982-89	8.0	35.0	25.2	6.0	15.8	Yes**
Guinea	1985, 1993		45.0		3.0	n/a	
Indonesia	1994	1.0	n/a	51.9	1.8		No
Indonesia	1997-		65-75	60.8	50-55	67.9	Yes**
Malaysia	1985-88	4.0	33.0	64.5	4.7	50.0	No
Mexico	1981;1994-9!	2.0	11.0	31	20.0	51.3	Yes**
Nigeria	1991		77.0		n/a	0.4	
Thailand	1997-		46.0	118.8	43.8	97.7	Yes**
Uruguay	1981-84	4.0	36.3	33.4	31.2	87.5	Yes**
Venezuela	1994-95	2.0	24.0	8.9	20.0	9.6	Yes**

Source: 1. Adapted from Laeven, Luc A. and Valencia, Fabian V., (September 2008) and
2. Hoggarth, G, Reis, R. and Saporta, V. (2001)

NB.: a) Estimated at peak and comparisons should be treated with caution
b) Average during crisis period; c) Estimates of the cumulative fiscal costs during restructuring period
d) Cost of Savings and Loans clean up

What happens when it fails?

- ENRON
- WorldCom
- Barings Bank
- Societe Generale
- Lehman Brothers
- J.P Morgan
- Barclays Bank
- Royal bank of Scotland
- AMCON in Nigeria

What happens when it fails?

- ENRON – Before bankruptcy in December 2001, one of global leading power, energy & utilities companies - employed 20,000 staff. "A" rated. Was one of Fortune's Top 100 companies to work for in America in 2000. Creative accounting. Chairman Ken Lay; CEO – Jeff Skilling; CFO – Andrew Fastow. Placed liabilities in shell companies – not appear in books. Fraudulent deals - Also led to demise of Arthur Andersen. Partly led to Sarbanes Oxley Act of 2002 (Public Company Accounting and Investor Protection Act). Corporate Governance rules – responsibility of directors; criminal penalties etc.

- WorldCom – was America's second largest long distance phone company (after AT & T). CEO Bernard Ebbers; CFO Scott Sullivan; Comptroller David Myers – aggressive growth strategy – tried to merge with Sprint in 2000. Not approved by regulators. Fraudulent Financial records from mid-1999 to 2002 – booking interconnectivity costs as capital instead of expenses and inflating revenues. Internal auditors unearthed $3.8BN in fraud. Arthur Andersen withdrew opinion. Bankruptcy July 2002.

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What happens when it fails?

- Lehman Brothers – Founded 1850. Fourth largest investment bank in US (after Goldman Sachs; Morgan Stanley and Merrill Lynch). Declared bankruptcy September 2008. following large exodus of clients; drastic losses in stock and downgrade of assets by credit rating agencies. Largest bankruptcy in US history! Holdings shared between Barclays (NA divisions) and Nomura (Asia-Pac, Europe and Middle East). Financial accounting gimmicks; sub-prime mortgage bets (large positions in securities backed by lower rated mortgages). In first half of 2008, lost 73% of value as credit markets continued to tighten – had to sell of $6bn of assets and lost $2.8bn.

- Bear Stearns – Founded 1923. Issued large amounts of asset-backed securities including mortgages (by Lewis Ranieri – "father of mortgage securities"). As losses mounted in 2006 and 2007, company actually increased exposure especially to mortgage backed securities which were central to sub-prime crisis. Sold to JP Morgan for $10/share from 52 week pre-crisis high of $133.20.

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What happens when it fails?

- Barings Bank – Oldest merchant bank in London (founded 1762) until collapse in 1995 after loss from unauthorized speculative trades by its Head Derivatives Trader, Nick Leeson in Singapore – lost GBP827m. Instead of buying and simultaneously selling, Leeson held on to the contract, gambling on future direction of Japanese markets. Internal challenges – doubled as both floor manager and head of settlement operations. No check and balance.

- Societe Generale – Jerome Kerviel – caused Eur4.9bn ($6.1bn) trading loss in 2008. one of largest in history. Arbitraging between equity derivatives and cash equity prices. Wiped off almost two years of pre-tax profits of SG's investment banking unit. Taking unhedged positions far in excess of desk limits up to Eur49.9bn (in excess of bank's total market cap) – disguising exposure with fake hedges. Highlights lack of risk experts on risk committees. States making a profit makes hierarchy turn blind eye

What happens when it fails?

- J.P Morgan – Losses on Trading/derivatives bet – Made by CIO in London – invests excess deposits to create interest rate hedge – brought in $4bn over last 3 years. Estimates could reach as much as $6bn - $9bn (versus Q1 profit of $5.4bn). CEO Jamie Dimon under pressure. Pay of responsible officers to be docked – little real impact.

- Barclays – Rate-rigging scandal brought down CEO, Bob Diamond. Fined GBP290m (approx $450m). Possible criminal prosecution. Glass-Steagall type action possible (division between investment and commercial banking). CEO lost $30m bonus

- RBS – IT glitch caused breakdown of service to customers – could they have tested on one of their brands or regionally before full rollout? Also fighting to keep LIBOR records private – rate fixing scandal

What happens when it fails?

- Cadbury – financial reporting scandal
- AMCON – "Bad Bank" set up in 2010
- Total loans acquired - over 12,000 loans valued $4.2 trillion (at cost of $1.7 trillion)
- Took over 3 banks – Afribank; PHB; Spring
- Assisted Union; Oceanic; Intercontinental etc to seek tie-ups
- Celebrated cases of superstar Bank CEOs. Former Oceanic CEO convicted. Other former CEOs in court - Intercontinental , PHB, Afribank.

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SO WHAT TO DO?

SO WHAT DO WE DO?

- So who is to save us?
  - Board
  - Executive Management
  - Internal Audit
  - Accounting firms
  - Rating agencies
  - Regulators

- All have failed.

Risk Governance

- Usually the board of directors have the following responsibilities:
- Select competent board members; and establish guidelines to govern the board organization and structures.
- Select competent executive officers, evaluate and compensate them accordingly;
- review and approve the management-developed strategy i.e. approve the overall risk-appetite of the institution;
- monitor the control of the environment;
- ensure that the necessary corrective actions are taken to remedy the situation;
- ensure the compliance of the institution with its legal and regulatory requirements;
- Directors are to perform these functions in the best interest of the shareholders and other stakeholders.

8 Principles for Bank Boards & Senior Management – By Basel Committee

- Principle 1: Board qualifications, capabilities and responsibilities
- Principle 2: Board's role regarding the bank's strategic objectives and corporate values
- Principle 3: Lines of responsibility & accountability
- Principle 4: Ensuring oversight by senior management
- Principle 5: Auditors and internal control functions
- Principle 6: Board & key executive compensation
- Principle 7: Transparent governance
- Principle 8: "Know your operational structure"

- For more info, please go to www.bis.org/BCBS

8 Principles

- ***1. Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the company.***
- **Board should have an adequate number of independent members**
  - Independence = ability to exercise objective judgment

- ***2. The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated through the banking organization***
  - Employees should be encouraged to raise concerns about illegal or unethical practices to the board or an independent committee without fear of reprisal or retaliation i.e. ***Whistleblowing to be encouraged***

8 Principles

- *3.* ***The board of directors should set and enforce clear lines of responsibility rand accountability throughout the organization***
  - Define authorities & key responsibilities

- *4.* ***The board should ensure that there is appropriate oversight by senior management consistent with board policy***
  - Senior management should have the necessary skills to manage the business
  - Under board's guidance, establish system of internal controls

8 Principles

- *5.* ***The board and senior management should effectively utilize the work conducted by the internal audit function, external auditors and internal control functions***
- External audits - the board and senior management should:
  - Engage external auditors to review internal controls relating to financial statements
  - Ensure that external auditors comply with applicable codes & standards of professional practice
  - Ensure that external auditors understand their duties

- 6. ***The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment***
    - Avoid compensation policies that create incentives for excessive risk-taking

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8 Principles

- 7. **The bank should be governed in a transparent manner.**

  Disclosure should be made on the bank's website, in its annual/periodic reports and/or in reports to supervisors about:
  - Board and senior management structure
  - Basic ownership structure & organizational structure
  - Code of business conduct and/or ethics code
  - Bank policies relating to conflicts of interest & related party transactions

- 8. **The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (i.e. "know-your-structure")**
  - Set clear corporate governance expectations for all relevant entities and business lines
  - Banks sometimes operate in jurisdictions, or employ structures, that lack or impair transparency

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Risk Governance

- Sarbanes Oxley Act of 2002 (“Public Company Accounting Reform and Investor Protection Act”) or SOX.
- Set enhanced or new standards for all US Public company boards, management and accounting firms. Enacted in reaction to number of major corporate and accounting scandals including Enron, Tyco, WorldCom etc. Cost billions of dollars when share prices collapsed and shook investor confidence
- Contains 11 sections ranging from additional Board responsibilities to criminal penalties. Covered issues such as auditor independence , corporate governance/conflict of interest, internal control assessment etc.
- Created new quasi-public agency Public Company Accounting Oversight Board

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Risk Governance

- Committee of Sponsoring Organizations is a joint initiative of 5 private sector organizations - American Accounting Association (AAA); American Institute of CPAs (AICPA); Financial Executives International (FEI); Institute of Management Accountants (IMA) and Institute of Internal Auditors (IIA)
- It is dedicated to providing thought leadership through development of frameworks and guidance on enterprise risk management, internal controls , corporate governance and fraud deterrence, among others.
- It was formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting ("The Thread way Commission " originally chaired by James C Thread way ,EVP and General Counsel of Paine Weber and former Commissioner of US SEC).
- Driven by various corporate political campaign finance and foreign corrupt practices, SEC and US Congress initiated reforms requiring companies to implement internal control programs

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Risk Governance

- Engaged Coopers and Lybrand to study issues and provide report on integrated framework on internal control. Published seminal work – Internal Control – Internal Framework in September 1992 (in four volumes)
- Essentially 5 framework concepts:
- Control environment – sets tone in organization. Includes integrity, ethical values, delegation of authority systems, people management etc
- Risk Assessment –identification and analysis of relevant risks to achievement of set objectives
- Control Activities – policies and procedures to ensure management activities are carried out. Include authorization; verification; segregation of duties; reconciliation etc.
- Information and communication: Key role – provide reports on operational, financial and compliance related information.
- Monitoring – Assess quality of the system's performance over time. Deficiencies detected should be reported and corrective action taken

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Risk Governance

- In 2001, given calls for increased corporate governance in wake of various scandals, COSO initiated a project and engaged PriceWaterhouse to develop a framework to enable firms evaluate and improve organization's risks in holistic manner.
- In 2004, COSO published Enterprise Risk Management – Integrated Framework.
- Looked at four categories of business objectives:
  - Strategic – High level goals, aligned with company's mission
  - Operations – effective and efficient use of resources
  - Reporting – reliability of reporting
  - Compliance – compliance with applicable laws and regulations
- While significant benefits, COSO acknowledges weakness – dependent on human judgment – susceptible to faulty decision making
- Currently working on 2012 update

Risk Governance

Current Version made up of Eight Framework Components

- Internal Environment – risk management philosophy and risk appetite, ethical values, etc
- Objective setting – Management must have process to set objectives and ensure it aligns with entity's mission and are consistent with risk appetite
- Event Identification – Internal and external events affecting achievement of objectives must be identified, distilling between risk and opportunity
- Risk Assessment – Risks are identified and analyzed considering likelihood and impact, as a basis for determining how they are managed.
- Risk response – Develop set of actions in line with risk appetite – avoid, accept, reduce or share risks
- Control Activities – Policies and procedures to ensure risk response is effectively implemented
- Information and Communication – relevant info in identified and communicated in firm and timetable for people to execute functions
- Monitoring – Entirety of enterprise risk management is monitored and modifications made as appropriate.

Risk Governance

- Cadbury Report – (Financial Aspects of Corporate Governance) – Chaired by Adrian Cadbury. Set up by Financial Reporting Council, London Stock Exchange and the Accountancy profession
- Sets out recommendations on arrangement on corporate boards and accounting systems. Published December 1992. Applied to listed companies from June 30, 1993
- Arising from series of events – Robert Maxwell's death shone spotlight on risky acquisitions being financed by diverting funds from pension funds of his companies; BCCI scandal with billions of dollars of losses and Polly Peck, a company which reported healthy profit one year and went bankrupt following year
- Key recommendations –
- Division of top responsibility – no one individual has powers of decision
- Majority of independent non-executive directors
- At least 3 non-executives on Audit Committee (oversee financial /accounting reporting
- Majority of non-executives on remuneration committee

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Risk Governance

The Hamper Committee report (1998) - developed some basic principles of good CorporateGovernance:

- Every listed company should be headed by an effective board which should lead and control the company.
- There are two key tasks at the top of every public company- running of the board (the chairman's role and the executive responsibility for the operation of the company's business (Chief executive's role). There should be a clear division of responsibilities between the two roles.
- The board should have a balance between executive and non- executive directors with at least 1/3rd from the latter. The majority of non-executives should be independent of the management
- There should be a formal and transparent procedure for the appointment of directors and all directors should offer themselves for re-election every three years.
- Levels of remunerations should be sufficient to attract and retain the directors to run the company successfully, but should not be excessive.
- The board should use the annual general meeting to communicate with the individual investors and encourage their participation.

Risk Governance

- **King Report**
- South Africa – issued 1994 (King I); 2002 (King II) and 2009 (King III)
- Requirement for companies listed on Joburg SE
- Institute of Directors asked retired Supreme Court Judge, Mervyn E. King to chair first official committee on corporate governance
- Is non-legislative - Uses “Apply or Explain” approach
- Consists of 3 elements: Leadership; Sustainability; Good corporate citizenship
- **King I**
- Board make-up
- Appointment to Board and guidance on maximum term of directors
- Determination and disclosure of remuneration
- Board meeting frequency
- Balanced annual reporting
- Requirement for effective auditing
- Company’s code of ethics

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Risk Governance

- **King II**
- Directors and responsibilities
- Risk Management
- Internal Audit
- Integrated sustainability reporting
- Accounting and auditing

- **King III**
- IT Governance
- Business Rescue
- Alternative Dispute Resolution
- Risk based internal audit
- Evaluation of Board and Director's performance
- Shareholder approval of non-executive director remuneration

Risk Governance

- Various other reports
- Turnbull Report (1999)
- Higgs Report (2003)
- Smith Report (2003)

Risk Governance

- Strengthen Regulation and oversight
  - CBN and SEC already quite activist in this regard
  - Code of corporate governance
  - Confirmation of directors and staff
  - Regular change of auditors
  - Risk-based supervision

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Risk Governance

- CBN
- Code of corporate governance – March 1 2006
- Approved persons circular June 2011 – 01/016
- Competency framework – Defined Significant roles – Chairman; MD; ED; Non-ED; Independents; Audit & Compliance; Finance; Risk;
- Defined Code of practice (exposure draft)

Risk Governance

- CBN (cont'd)

- CRO forum initiative
- Common year-end
- Risk-based supervision framework
- Portfolio Management - Exposure to PSG
- Capital raising for foreign subsidiaries

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Risk Governance

- SEC – New Code of corporate governance –
- Key Elements
  - Board Composition
  - Minimum of 5 members – majority of Non-Executive Directors with at least one independent director
  - Not more than 2 members of a family at one time
  - Discourages membership on Board of two or more companies in similar industries

Risk Governance

- Board Committees
  - In addition to statutory Audit Committee (as required by CAMA), recommends Governance & Nomination Committee as well as Risk Management Committee
  - Only Directors expected to be members of these committees. Must have requisite skills and experience
  - Only Non-Executive Directors recommended for Governance & Nomination Committee

Risk Governance

- Governance & Nomination
  - Oversee nomination, remuneration, performance management and succession planning processes

- Risk Management
  - Oversight of Risk Governance and disclosures
  - Risk Profile definition; Risk-reward strategy; Risk Mgt Framework; Key Risk Identification; Adequacy of detection, prevention & reporting mechanisms

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Risk Governance

- Statutory Audit Committees
  - Constitute suitably qualified Audit Committee
  - Oversight of Internal and External Audits, Financial Reporting and Compliance
  - Provide assurance on effectiveness of internal controls and risk management practices
  - Oversee management processes for identification of significant fraud risks and ensuring adequacy of detection, prevention and reporting

Risk Governance

- Delegation of Authority Framework
  - Properly defined document for delegation of authority over financial and non-financial matters
- Board Evaluation
  - Formal and rigorous annual evaluation of the Board, the committees and individual directors
- Board Training
  - Induction/ongoing training to update knowledge & skills to enable effective discharge of functions

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Risk Governance

- Strengthening of Assurance Functions
  - Internal Audit: establish an effective risk-based internal audit function to provide assurance over effectiveness of the governance, risk management and internal control functions
  - Report at least once a year at audit meetings
  - External audit of effectiveness of Internal Audit function recommended at least once every 3 years

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Risk Governance

- Rotation of External Auditors
  - Rotate every 10 years. Disengaged firm may be re-appointed after cooling off period of 7 years. Periodic rotation of audit partners and personnel is encouraged
- Disclosures
  - Provide adequate info on capital structure, corporate governance practices, related party transactions, risk management policies, levels of compliance etc

Risk Governance

- Common Threads:
- Independent and knowledgeable Board
- Nomination – of competent executives
- Compensation – incentives for Risk taking –longer term
- Strength of Internal Control and Assurance functions – Internal and External Audits
- Reporting – accurate and complete info for decisions

Risk Governance

- Tie Risk to Strategy – Risk Appetite
-
- Hold adequate capital for risk taking
- Now appears there is a need to factor in tail events
- Engage expertise
- At both Board level and external consultancy
- Deploy appropriate Technology

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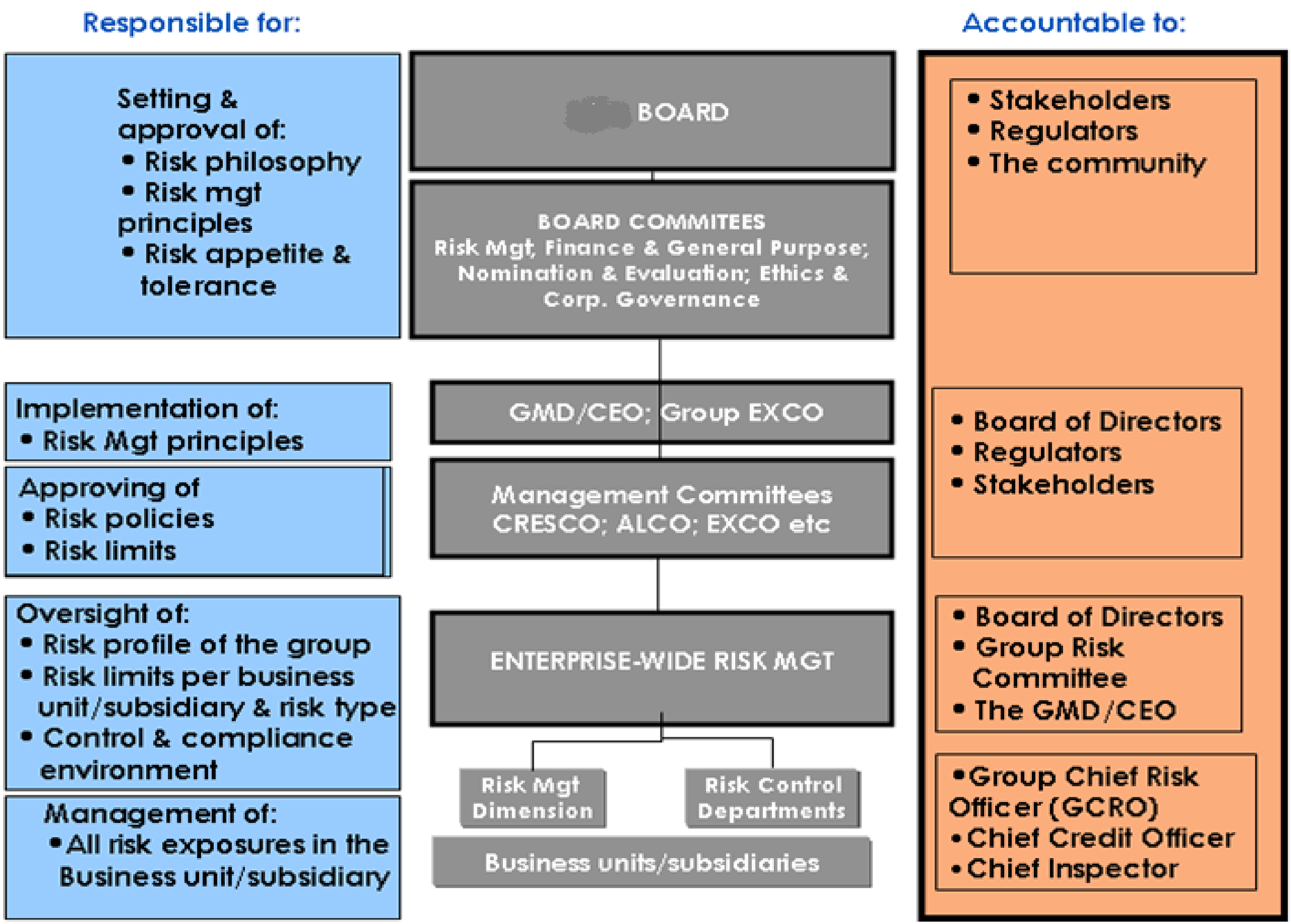
DISCUSSIONS

…A Strong Corporate Governance Framework



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Key risk management steps

Identify

- Identify the risk inherent in achieving the Bank's goals and objectives.
- Establish risk appetite across the entire risk spectrum.
- Establish and communicate risk management frameworks

Assess

- Build accurate and consistence risk assessment.
- Establish and implement measurement reporting standards/meth-odologies.
- Build a risk profile for the Bank.

Control

- Establish key control processes, practices, and reporting requirements.
- Monitor the effectiveness of control.
- Ensure all the Bank's exposures are adequately identified, measured and managed in accordance with Board approved frameworks.
- Provide early warning signals.
- Ensure risk management practices are adequately and appropriate for managing the Bank's risks.

Report

- Report areas of stress where crystallization of risks is imminent
- Present remedial actions to reduce and/or mitigate such risks.
- Report on sensitive and key risk indicators.
- Communicate with relevant parties.

Manage and Challenge

- Review and challenge all aspects of the Bank's risk profile.
- Advise on optimizing and improving the Bank's risk profile.
- Reviewing and challenge risk management practices.

THANK YOU

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