

# Executive Roundtable and Professional Placements

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## Session 4, Part 2

### International Responses to Current Financial Turbulence: Governance and Financial Stability

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### **Background**

Prudential regulation and supervision provide the foundation for a stable financial system. The stability of individual institutions within the financial system rests on high standards of corporate governance. There is therefore a tight nexus between the objectives of prudential regulation and corporate governance of financial institutions.

The linkages can be illustrated as follows:

*Effective corporate governance > institutional stability > public confidence > systemic stability > macroeconomic performance*

Defective corporate governance in major financial institutions inevitably results in deleterious economic consequences, quite apart from the losses sustained by shareholders of those institutions (the fallout from the sub-prime episode in the US being an obvious contemporary example).

For these reasons, the demands on corporate governance in financial institutions are even more intense than for corporations in other industries.

Australian financial institutions employ and observe high standards of corporate governance. For this reason the direct effects of current international financial turbulence on Australian institutions have been relatively minor (despite pressures on margins, credit growth, bad debt provisions and share prices).

### **Framework**

Corporate governance embraces the role and responsibilities of the board of directors and senior management in directing the business performance and sustainability of financial institutions.

From a prudential perspective, the governance framework can be outlined as follows:

- Board of directors (including board committees)
- CEO
- Heads of business units
- Heads of risk management, compliance and audit functions

As ultimate responsibility for the institution's prudential viability resides with the board of directors, it is appropriate to regard the board as the focal point of the corporate governance system. Focusing at the board level also has the advantage of avoiding the need to distinguish between governance functions and business management functions.

At the core of the prudential dimension of the governance challenge is the need for the board to determine the risk appetite of the institution, understand and monitor its risk profile and ensure that capital adequately reflects the aggregate risk position.

Meeting this governance challenge involves structural, process, methodological and people issues.

### **Structure**

All the directors are responsible for the institution's financial soundness and prudent approach to risk management. Within this collective responsibility, there is a compelling case for a **risk management committee of the board**.

To ensure that the risk management committee is free from undue influence, it should be chaired by an **independent director other than the board chairman**.

The committee should comprise at least three independent directors who should comprise the majority (and may well be the entirety) of its membership.

There are no hard and fast rules about whether it is permissible for the board chairman and CEO to be committee members. Care needs to be taken, however, that the committee is able to form an independent view of risk issues without undue influence by strong personalities with a bias towards business development.

### **Role**

The risk management committee provides dedicated oversight, on behalf of the full board, of senior management's activities in managing credit, market, funding, liquidity, operational, compliance and other risks of the institution.

More specifically, a best practice model involves the following key functions for the risk management committee:

- To construct and propose the institution's **risk appetite** for approval by the full board
- Oversee the institution's **credit policies**
- Ensure the existence of **credit underwriting standards** consistent with risk/return requirements established by the board
- Approve policies and procedures to manage **market, funding and liquidity risks**
- Ratify **operational risk** policies for approval by the board
- Establish the integrity of an **integrated risk management framework** designed to produce a combined picture of all risks across the institution
- Monitor measurement of **aggregate risks incurred** against the approved risk appetite

### Process

The role, responsibilities and membership of the committee should be clearly disclosed.

Consistent with the demands of its responsibilities, the committee should meet relatively frequently – a minimum of six times a year would be consistent with best practice, with greater frequency being required where circumstances dictate.

Given that all board members are accountable for the financial soundness of the institution, non-executive directors who are not members of the risk committee should be welcome to attend committee meetings **as observers**.

At least annually the committee should meet with the chief risk officer in the absence of other management (including the CEO).

### Methodology

The committee must establish to its satisfaction the methodology that underpins the **integrated risk management model** that is employed to identify, assess, manage and report risks on a consistent and reliable basis across the institution.

### People

All board members must meet “fit and proper” tests and bring to the board particular knowledge, skills and experience that, in combination across the board, creates the balance and breadth of expertise needed to govern a complex institution.

Within the board, some directors will have skills and experience that make them particularly well qualified to serve on the risk committee. Care in committee member selection is therefore vitally important.

In particular, the committee chairman should be well qualified to carry out what is a highly technical role. In addition, the committee chairman needs to have the personal stature to withstand the influence of strong personalities in the senior executive ranks of the business.

Further, all committee members should possess a clear aptitude for exercising independent judgement without being unduly swayed by senior executives or technical experts within the business.

To assist the committee members to deepen their understanding of risk management issues there should be:

- A well designed **induction program** providing comprehensive coverage of all the risk management issues and methodologies that the committee needs to address
- A program of **continuing education** comprising information sessions and written material on new risk issues and developments in risk management techniques (it should be open to all directors to attend these information sessions).