Comment by
Independent Audit Limited
on

Second Part of CEBS' Technical Advice to the European Commission on Liquidity Risk Management:
Analysis of specific issues listed by the Commission and challenges not currently addressed in the EEA

by the
Committee of European Banking Supervisors

1 August 2008

INDEPENDENT
AUDIT LIMITED

EXECUTIVE SUMMARY

Role of the board of directors / workload

- Boards of directors in financial institutions are in danger of being overloaded with tasks, inhibiting their ability to fulfil their primary function of oversight of executive management of risk.
- CEBS' Recommendation 1 adds to the burden on boards of directors in relation to a recently broadly manifested and critical risk – liquidity risk management.
- Recommendation 1 should **emphasise** the role of the board of directors in relation to **oversight** of executives' efforts and performance in relation to risk management, and **review and approval** of risk documentation prepared and submitted by management.

Risk appetite / risk tolerance

- While boards of directors are accountable for definition of risk appetite and risk tolerance, practising directors find these issues problematic, and consider them to be evolving in use in their institutions. Again, boards of directors will require that management prepare and present for review and approval analyses of the firm's risk capacity, risk tolerance and risk appetite.
- Recommendation 1 should **emphasise** the role of the board of directors in relation to **review and approval** of analyses of the firm's risk capacity, risk tolerance and risk appetite, which will have been prepared by the firm's strategy and risk management functions.

Internal governance

- The liquidity paper would be enhanced by a discussion of the importance of **behaviour** in the firm supporting the firm's risk management efforts within and across the firm; *see more detailed statement of recommendations at para. 27*.

Definition of internal governance

- Executives and managers have a responsibility to manage behaviours effectively, including effective communication of behavioural expectations periodic observation and assessment of behaviour, and enforcement against transgressions. These actions are an essential element of effective internal governance.
- We recommend to CEBS that it **incorporate** this behavioural aspect of governance in its definition of internal governance, and that an appropriately-amended definition be incorporated in to CP19.

INTRODUCTION

1. This note comments on the Committee of European Banking Supervisors' (CEBS) paper *Second Part of CEBS' Technical Advice to the European Commission on Liquidity Risk Management* ('the CEBS paper').

2. In this note, we focus on CEBS' recommendations and observations in relation to the roles and responsibilities of boards of directors and governance.

BACKGROUND ON INDEPENDENT AUDIT LIMITED

3. Independent Audit Limited is a specialist advisory firm based in London. We advise major companies in all sectors on their corporate governance and related business practices. We work with a range of FTSE 350 financial institutions, as well as other major financial institutions, in these areas.

4. In addition, we seek to contribute actively, concisely and constructively to the debate in regulatory and professional circles on issues of corporate governance and related topics of risk management, internal control and compliance. Our experience in working with boards of directors, their committees and executives makes us ideally placed to contribute to regulatory and professional debates these issues, where often the vital perspective of boards of directors is not fully considered.

5. Our objective in presenting this response to the CEBS paper is to raise issues of interest and relevance to board directors and therefore to their contribution to the financial institutions on whose boards they serve.

RESPONSE TO CEBS' TECHNICAL ADVICE ON LIQUIDITY RISK MANAGEMENT

The role of the board of directors

6. The first recommendation of the CEBS paper states:

> **Recommendation 1**
> The Board of Directors should define a liquidity risk strategy and set management policies that are suited to the institution's level of liquidity risk, its role in the financial system, its current and prospective activities, and its level of risk tolerance. The Board should have a clear view of the risks implied by its degree of reliance on maturity transformation, and should ensure that an adequate level of long-term funding is in place. Its strategy and policies should consider both normal and stressed times and should be reviewed regularly, including (at a minimum) when there are

material changes. Senior management should define adequate processes to implement these strategies and policies.[1]

7. The role and responsibilities of boards of directors are significant, complex and increasingly onerous. Where there is a unitary board structure, responsibility for independent board-level review of risk-related issues commonly falls to the independent, non-executive directors. These directors are, almost by definition, part-time.

8. Many of Europe's larger financial institutions are listed (or joint-listed) in the UK. Recently, Independent Audit Limited hosted a private discussion for chairs of audit committees of major financial institutions. The attendees represented over 30% of the value by market capitalisation of UK and international banking and insurance companies listed on the main board of the London Stock Exchange. The purpose of the meeting was to discuss pressures facing audit committees in such institutions, and to allow these senior non-executives to share knowledge and leading practices.

Non-executive directors' workload

9. In the discussion, a common theme emerged: that audit committees were responsible (in most of the firms represented) to oversee the institution's risk management, and that the task is a very demanding one. Participants expressed concern about the potentially endless scope of the risk responsibilities of audit / risk committee membership, and how to keep the tasks down to "manageable proportions".

10. The problems experienced by many firms since mid-2007 have their external origins in liquidity constraints in the wholesale funding market. The regulatory and supervisory response has been a plethora of reports on liquidity risk and liquidity risk management. Yet, while the extent of liquidity concerns are new, the recognition of liquidity risk as a critical aspect of firm risk attention is not. Indeed, liquidity risk management is specifically identified in Annex V of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (part of the capital requirements directives).

11. Our concern is that new, specific demands relating to liquidity risk are being heaped upon non-executive directors whose time is already heavily stretched. We do not mean to suggest that effective management of liquidity risk is not critical to the sustainable performance and sometimes the survival of the firm; rather that it is one of the spread of risk classes and risk management issues to which the board of directors (perhaps through delegated committees) must pay attention. We believe it would be better cast as such, since threats to the firm's survival may come from any risk class.

Risk appetite / risk tolerance

12. At Independent Audit Limited's meeting of major financial institutions' audit committee chairs, the issue of risk appetite (or tolerance) was singled out for attention. Participants considered the concept to be complex and difficult to define and use, and that it continues to evolve in use in their institutions. The CEBS' paper treats risk tolerance as a purely quantifiable issue, and, in probabilistic terms (assuming adequate knowledge and

[1] CEBS paper, p.27

information), it can be. However, the issue can also be approached from a different perspective, such as that referred to in the Senior Supervisors' Group (SSG) report on risk management practices:

> How senior management at various firms approached the current market turmoil appears to have differed in a number of important ways that help to explain firms' outcomes through year-end 2007. Four such differences in approaches included the following *[inter alia]* :
>
> - the balance that each firm's senior management in general achieved between its desire to do business and its appetite for risk as reflected in the tone set for developing or enforcing controls on the resulting risks[2]

13. By highlighting risk tolerance or appetite as being reflected "in the tone set for developing or enforcing controls on the (sic) risks" resulting from firms' business activities, SSG identifies the importance of both quantitative or technical risk management and **behavioural** aspects of fostering an environment of control. We believe that acknowledgement of this point and its implications for setting behaviour expectations within firms would strengthen the CEBS proposals.

Clarity of board and executive responsibilities

14. Participants at Independent Audit Limited's meeting of major financial institutions' audit committee chairs noted that it is essential to maintain a clear distinction between risk oversight (a board responsibility) and risk management (an executive responsibility). The Institute for International Finance highlights this distinction and its recommendations on liquidity.

15 It recommends[3] (Recommendation 4) that the board (or a committee thereof under delegated authority) . . .

a. **approve and review annually**:
   - the strategy and significant policies related to the management of funding liquidity risk under both normal and stressed conditions;

b. **approve documents** which:
   - identify key funding liquidity limits and approval levels, as well as those authorities delegated to senior management committees or those executives accountable for approving detailed strategies, goals, procedures, limits, and exceptions;

c. on an **on-going basis**:
   - ensure that senior management takes necessary steps to appropriately manage, measure, monitor, and control funding liquidity risk in an integrated fashion with other closely associated risks to facilitate enterprise-wide risk-management solutions;
   - be informed regularly [by executive management] of the funding liquidity position of the firm (metrics, indicators, and outlooks); and

---

2 SSG, p.7

3 Institute for International Finance (March 2007), Principles of Liquidity Risk Management, p.20

- be (sic) notified immediately [by executive management] if there are any material changes in the firm's current or prospective funding liquidity positions.

This set of recommendations both clarifies the respective roles of the board of directors and management, and makes explicit the oversight focus of the board.

16. We urge CEBS to . . .

    16.1. adopt a similarly clear distinction between the risk oversight role of the board of directors and the risk management and oversight roles of the executive;
    16.2. clarify the fit of the role of the board of directors in relation to liquidity risk within the spread of risks which the board must oversee;
    16.3. acknowledge the specialised technical nature of liquidity and some other quantitatively-managed risk classes and acknowledge the suitability of consideration by appropriately qualified, delegated board committee of such issues;
    16.4. make explicit that the role of non-executive directors and risk oversight by the board of directors is to ensure that the insight, experience and independent viewpoint of directors be brought to bear on issues of key concerns to firms, such as: aggregate risk position relative to the risk-holding capacitiy and preferences of the firm, key and emerging risks, extensions to product and risk portfolios, and the assumptions underlying risk management analyses; and
    16.5. make explicit that the oversight role of the board of directors is enhanced by concentration on competencies, behavioural and assurance aspects of risk management in the firm, in addition to analytical approaches to risk management in general, and liquidity risk management in particular.

17. These themes are picked up by the IIF, in their recent paper on market best practices, in which they state:

> Recommendation I.1: Firms should establish clear policies that define risk management as the responsibility of each institution's senior management, in particular the CEO, subject to the oversight of the Board. Senior management should be involved in the risk-control process, and both the Board and senior management should regard risk management and control as essential aspects of the business.[4]

and

> Recommendation I.9: The Board should review and periodically affirm the firm's risk appetite as proposed by senior management. In so doing, the Board should assure itself that management has comprehensively considered the firm's risks and has applied appropriate processes and resources to manage those risks.[5]

---

[4] Institute for International Finance (July 2008), Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations, p. 32

[5] *ibid*, p. 35

18. These recommendations recognize that the board of directors' role is to review, discuss, challenge and critique the work of management, rather than to prepare documents or analyses, define strategies or set policies. This positioning of the role of the board of directors would present the role of the board more realistically, and reduce the probability of unrealistic expectations of board activities and resulting overload of directors.

Internal governance

19. There is limited comment in the CEBS' paper on behaviour of business and support function managers, which contrasts with the critical role of individuals' and groups' behaviour in managing risks of any class, including liquidity.

20. As an empirically-based review by key supervisors of market-leading firms, the SSG report should carry considerable weight. While the report does not address liquidity risk in isolation, many of its observations cover the role of behaviour, and the contrast in behaviour between well-performing and less well-performing firms within its supervisory ambit. The following points are, in part, drawn from that report.

21. We recommend to CEBS that it consider more fully the following issues:

    22.1. The importance of a "continuous dialogue" between business areas and risk management functions on whether the firm is balancing appropriately its risk appetite and risk controls;
    22.2. The essential role of observation and enforcement of balance-sheet limits in ensuring the integrity and comprehensiveness of the picture of the firm of the risks it holds, and of its understanding of those risks;
    22.3. The contribution of challenge by senior management of assumptions regarding risks;
    22.4. The utility of involvement of senior managers in understanding and responding to emerging risks;
    22.5. The requirement for adequate skill in senior management to review and challenge a full range risks, "since the source of the next disruption is impossible to predict"[6];
    22.6. The utility of forums, which include business line leaders, to discuss all significant risk exposures across the firm which meet on a frequent basis;
    22.7. The need for timely provision of accurate and comprehensive information to senior management;
    22.8. The benefits of creating an environment in which business and risk managers can escalate concerns about emerging risks to senior business and risk officers;
    22.9. The dangers of formalized, hierarchical structures will serve to filter, delay or distort information provided to senior management;
    22.10. The benefits of sharing risk information across business lines as well as within hierarchies or silos;
    22.11. The imperative of business areas viewing risk management and risk control functions as integral to effective management and business performance.

6 SSG, p.8

23. Few of these more behavioural issues of internal governance come through in the CEBS draft. However, they are likely to determine both the influence and the efficacy of risk management and risk control functions across all risk classes, including liquidity risk. We encourage additional comment thereon by CEBS in its report to the Commission.

Definition of internal governance

24. In CEBS' January 2006 paper 'Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CP03 revised)', Annex 1 includes a glossary entry for internal governance:

> In these guidelines, the term 'internal governance' is used, as opposed to the term 'corporate governance.' While corporate governance has a wider scope and includes issues that concern the shareholders and other stakeholders of an institution, internal governance focuses on the responsibility of management body (both supervisory and management functions). It is mainly concerned with setting the institution's business objectives and its appetite for risk, how the business of the institution is organised, how responsibilities and authority are allocated, how reporting lines are set up and what information they convey, and how internal control (including risk control, compliance, and internal audit) is organised.

25. This definition is not provided in the CP19 paper. However, if CEBS intended to change its use of the term, it is likely an alternative definition would have been provided.

26. The limitation of the definition of internal control is what CEBS means by the term 'organised'. As written, it seems to mean structural or formal organisation. However, governance (be it corporate or internal) is critically dependent on the people who effect it, and the impact (or effectiveness) of their actions and interactions with others. We believe addressing explicitly this behavioural aspect of governance is vital to organisations achieving effective internal control, and contributes to what is often referred to as the 'control culture' of the firm, or its 'risk culture'.

27. Organisational culture (and 'control culture' and 'risk culture') cannot be developed mechanistically or deterministically. It emerges principally from the observed actions, behaviours, rewards and sanctions espoused, enacted and enforced by senior personnel. Executives and managers have a responsibility to encourage behaviours that will be consistent with (i) effective identification, consideration and management of risk and (ii) robust internal control (as defined elsewhere). Management actions should include effective communication of behavioural expectations, periodic observation and assessment of behaviour, and enforcement against transgressions of those expectations.

28. We **recommend** to CEBS that it **incorporate** this behavioural aspect of governance in its definition of internal governance, and that an appropriately-amended definition be incorporated in to CP19.