RISK MANAGEMENT CONFERENCE

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It is indeed my pleasure to interact with the risk experts and senior officials of the banking industry. It has been our endeavor to have frequent interaction with the banks to share our views on issues of significant importance and provide guidance. The organization of this conference in collaboration with IFC is another step towards meeting our commitment to add value and input as a supervisor.

Over the years, the importance of risk management has been elevated to a significant level around the globe and the State Bank has tried to meet these rising challenges in this field by ensuring meticulous compliance of prudential regulations and other directives issued by SBP from time to time. I would like to mention a few of the initiatives taken by SBP, for example, keeping in view the importance of policy framework, the State Bank, from time to time, issued instructions in the form of various Circulars and Guidelines. In 2007, in order to facilitate banks / DFIs and to ensure compliance of all previous regulatory requirements; we issued consolidated instructions on policy framework. The objective of this exercise was to ensure that banks/DFIs have policies in various areas that are synchronized and have uniformity according to varied nature of their respective operations. Banks / DFIs were advised to formulate policies in the following areas and ensure their regular updation.

1. Risk Management Policy
2. Credit Policy
3. Treasury & Investment Policy
4. Internal Control System and Audit Policy
5. I.T. Security Policy
6. Human Resource Policy
7. Expenditure Policy
8. Accounting & Disclosure Policy

Secondly as you all know, a major ongoing development is the implementation of the international Basel II capital accord in Pakistan. Basel II is intended to enhance the quality of risk management by tying regulatory capital more closely to institutions' underlying risks and by requiring strong internal systems for evaluating credit and other risks. Although Basel II will by no means eliminate future episodes of financial turbulence, it should help to make financial institutions more resilient to shocks and thus enhance overall financial stability. At the same time, we must ensure that the Basel II framework appropriately reflects the lessons of recent events in the international financial markets. The Basel Committee has been evaluating how the framework might be strengthened in areas such as the capital treatment of off-balance-sheet vehicles and the use of credit ratings to determine capital charges. The relatively lengthy transition to Basel II will allow more opportunity to handle the challenges which arise during this transitional phase and make necessary adjustments to the framework.

In addition to the initiatives taken to improve the risk management framework of banks, SBP has also tried to institute a risk sensitive supervisory mechanism. Our offsite monitoring of banks is based on a framework called Institutional risk assessment framework (IRAF). The framework envisages a collaborative and seamless supervisory focus amongst the various supervisory departments within the SBP. It is based on the following four inputs on which the banks/DFIs are evaluated:-

(1) Compliance with Standards, Codes and Guidelines

(2) Supervisory and Regulatory Information

(3) Financial Performance and Conditions

(4) Market Information and Intelligence

During onsite examination, we try to evaluate the performance of banks on key performance indicators. The onsite examination is based on CAMELS rating system which assesses the performance of banks vis-à-vis its capital adequacy, Asset Quality, Management performance, Earnings, Liquidity risk, Sensitivity to interest rate and System and Controls.

In order to be effective, the concern and tone for the risk management must start at the top. You would agree that while the management may get influenced by business targets and short term profitability, the Board, representing owner's perspective, always targets for long term viability and sustained growth of the bank. By virtue of this different perspective and its legal powers, the board is better positioned to enhance the role of risk management in a bank. That is why SBP has always emphasized the involvement of the Board and made it accountable for establishing enterprise wide risk management framework.

While the overall responsibility of risk management rests with the Board of Directors, it is the duty of senior management to transform the strategic direction set by the Board in the shape of policies and procedures and to institute an effective hierarchy to execute and implement those policies. SBP desires a more active role of Board in setting the strategic direction of the bank as well as to bring them under accountability. The formulation of policies relating to risk management only would not solve the purpose unless these were clear and effectively communicated down the line. Senior management must ensure that these policies are embedded in the culture of the organization. For the value of risk management to be realized, integration is essential. Therefore, the emphasis should be on integrating risk management into the existing management structure and processes, rather than operating as an appendage.

This conference is significant in the sense that it comes at a time when the financial services sector across the world is in the midst of a crises. Since the disruption has become acute, there is a debate over a number of issues relating to management and supervision of financial services industry. Many experts are advocating that rules based supervision was more effective compared with the present relatively 'liberal' supervisory regime. Many industry experts are also questioning risk management practices, especially the risk assessment techniques used by the industry. These experts claim that formula oriented quants have been fooled by randomness; in the real world, prices of financial assets are governed by human psychology not by laws of physics. On the other side are the people justifying the usefulness of the models claiming that the models were never meant to replace expert judgment and their purpose was rather to support experts in making a decision. The quantitative theorists always based their models on a bell curve of predictability of various outcomes. We are now in the extreme left tail of such outcomes in many areas. The growth and diversity that the financial sector has witnessed over the last few decades could not be made without these models because much of the growth was fueled by new financial instruments which burgeoned because many believe, perhaps wrongly, that using these instruments reduced or contained risks. This appeared to be true within the normal limits around the mean of the bell curve, but did not hold up at the extreme tails of the curve. There can be endless debate over these issues, nevertheless one can say for sure that this turmoil in the financial sector does not preclude the importance of the risk management function, rather it further signifies the importance of risk management in financial institutions.

Like any real life crisis, the present turmoil in the financial sector provides an opportunity to learn from the financial world's mistakes and overzealousness. This gives us the opportunity to look back and see what went wrong and structure our own financial houses so that this does not happen to us, or so severely affect the world again. In this regard I think the most significant lesson that we have learnt from recent events is the importance of fundamentals in risk management. For instance there is a basic rule since inception of banks which says 'do not put all your eggs in one basket'. Had this simple rule been followed, many institutions could have avoided huge losses. Today I take the opportunity to highlight some fundamental principles that form the cornerstone of risk management and if followed in letter and spirit can shield financial institutions from significant losses. These rules are simple and equally applicable on small institutions. Being simple however means these are simple to understand; nevertheless implementing some of these fundamentals can be quite difficult.

Governance

A sturdy risk management framework in any institution cannot be established unless it is given due recognition by its board and senior management. Risk Management is not just a regulatory compliance issue; it is the apparatus that will help you deal with the peril on your way towards achieving organizational objectives. In this regard a few aspects call for the attention of the board members and CEOs;

- The purpose of a Risk Analysis Team is to have impartial and unbiased assessment of risk with no favoritism towards any business unit and its unbiased dissemination to the senior management and board. Obviously this can be accomplished only if the function is independent of risk units of the organization and which reports directly to the CEO regularly AND the Board periodically.

- The independent Risk Analysis Team can only be effective if they have influence in day to day operations of the institutions. In this regard, the support of the Board and CEO is a prerequisite. I would suggest two things, firstly the stature of Chief Risk Officer should be equivalent to the other business units and secondly there should be frequent dialogues between the CRO and senior management (CEO & Heads of various business units). The latter would also help in developing an understanding of Enterprise-wide risk and ensure that the risks are not managed in silos. A report prepared by Senior Supervisory Group (SSG) on observations on risk management practices during recent market turbulence also highlights that the institutions which had developed the practice of having active dialogue were able to identify risk in year 2006 when it was practical to manage excessive risks.

- While it is important to have an independent Risk Analysis Team, one cannot absolve the business units of their responsibility in relation to risk management. Risk Management can be durable if it is entwined in the overall culture of the organization. The people who are taking risks must know the risks and rewards associated with the transactions they are undertaking and the risk appetite as well as the tolerance limits. Therefore the risk managers in each business unit must understand how their independent risk management within their division integrates within the entire organization. Therefore, they must be part of the business plan, strategic plan, and annual budgeting process where the degree of various risks is assessed, reassessed, and balanced within the organization to comprehend and mitigate the degree of risk to be undertaken on a planned basis. The requirement is always to balance the level of yield and profitability against the expected higher level of risk assumed with each step up the yield curve.

- An important element of risk management is the establishment of risk discipline and oversight to insure that additions to or changes in the asset liability mix are consistent with the overall plan. Risk managers have the responsibility to establish limits and controls and review the same whenever required. Senior management has the responsibility to develop a risk culture by ensuring that risk taking units adhere to these limits. A dormant limit structure in which breaches are not taken seriously is useless and can lead to a disastrous situation.

Information System

A reliable and respected information system is the foundation of risk identification and measurement. Timely availability of accurate information is essential to have meaningful assessment of risk. I acknowledge that many banks realized its importance and invested significant resources in improving their IT systems. However, I would like to emphasize that while reviewing core banking or other IT systems may provide the ability to capture and disseminate information, banks may also need to review basic procedures adopted for capturing data. For instance, the application form of a retail borrower may need to be sufficiently modified to capture the data necessary to design a scoring system or procedures may need to be reviewed to capture data relating to collateral held against loans. In large banks, the collection of accurate and real-time information can be a difficult and a challenging task which necessitates devotion of sufficient resources to ensure veracity of data. Only a sound and complete information system, rich with information, will enable risk managers to properly assess risk and accomplish their task.

Risk Identification & Measurement

Besides accurate information and frequent dialogue with business units that I have already discussed, institutions need to take into account a few other things while designing and implementing risk measurement systems.

- Risk Measures adopted should encompass the whole organization. Risk identified in silos may undermine the enterprise wide risk the overall institution is facing.

- Banks may use multiple techniques for assessment of risk factors which will add additional dimension and depth when viewing risk from different perspectives and in different economic environments. For instance in case of interest rate risk there is an earnings perspective and economic value perspective. Both these techniques can be useful in assessing implications of interest rate risk on a banks' balance sheet. One important thing in respect of risk quantification is that whatsoever risk measures a bank is using, these should be flexible and allow managers to change the underlying assumptions. The SSG report highlights that during the recent financial turmoil, institutions using multiple and more adaptive measures performed better as compared with those with static risk measurement processes. That is to say the models need to be able to do simulations of various economc scenarios, which can be tested at the norm, and both tails of the bell curve of probable economic and rate scenario outcomes.

- Banks should also use qualitative analysis in addition to quantitative risk measures. In effect the predictability of quantitative outcomes is highly dependent on the qualitative nature of the assets, and similar stability of liability accounts. The strength of the prediction becomes higher with greater soundness of the asset in question and relative soundness and security of the institution to maintain its liability access to markets and depositors and counterparties.

- Risk measurement should be augmented by analyzing the bank's position under extreme but plausible scenarios. Stress testing has gained further significance in the aftermath of the recent financial turmoil. In designing stress scenarios it may be noted that the past may not always be indicative of future events, meaning that banks should be somewhat creative in designing potential shocks.

  The State bank of Pakistan has given guidelines to banks on stress testing and it has been mandatory for them to submit results of their stress test semiannually. SBP is also working on refining its guidelines that would be broadly designed so as to have applicability across all banks. Banks are expected not to sit on the bare minimum standards set by SBP but should work on improving their stress test framework. The banks' internal stress testing framework should be tailored keeping in view the product diversity and its information system. Obviously the internal stress test should be conducted on a frequent basis.

Liquidity Management

The recent liquidity crisis that some banks have witnessed reminds us of the importance of liquidity risk management. We have observed that only those banks which suffered liquidity problems were relying on large institutional deposits suggesting that such institutions need more vigorous liquidity risk management framework. Further during times of system-wide stress, liquidity shocks can become correlated so that the same factors that can lead to liquidity problems for the bank's assets, can simultaneously put pressure on the banks' own funding liquidity.

The SSG report points out that effective management of liquidity was one of the factors that differentiated the better performing institutions from those which could not perform well during the recent global financial crisis. These institutions aligned their treasury operations more closely with the risk management processes, incorporated information across the institution in actual and contingency liquidity planning and created internal pricing mechanism that provided incentives to business lines to control activities that might otherwise lead to significant balance sheet growth or reduction in capital. Generally the more dependent a bank is on unstable borrowed funds, the more liquidity it needs to maintain as an offset in crisis periods. This will also relate to the underlying volatility of values n assets it holds as a back up to general liquidity.

These were a few basic principles which had also been emphasized by SBP in the risk management guidelines issued in year 2003. I appreciate the progress that some banks have made over the past few years in the area of the analysis of risk management. However some banks need to take serious initiatives towards establishment of effective risk management in planning and growth of day to day business. I would reiterate that risk management is not a cost center and it will help you achieve sustainable growth and long term viability. As the risk management in many banks is still in a development phase, I would suggest CROs develop a long term strategy within respect of risk management. On the basis of that strategy they can set short term achievable goals.

We have been generally fortunate here in Pakistan to have not been greatly involved in the calamity which has hit the major banks of the world. However, we must not be content that we have avoided those catastrophes. We must understand that a much deeper economic setback for the world can impact us here as well. We are witnessing what some have termed a 100 year even, not unlike a tsunami or hurricane.

We must further develop our own risk management analysis systems and incorporate it into our management culture so as to avoid the dangerous tails of the bell curve which can be death of institutions as we have witnessed worldwide. ** Banks need to develop or buy risk analysis systems which they can easily understand and fine useable While we would like to achieve excellence, the goal is not to develop or purchase the most expensive system but have one which is relevant to the institution and usable. It is understood that such a system needs to be flexible and develop with time. Adaptability to your institution and future needs is important so it does not become outmoded. Above all it must be easily understood by both of us. As regulators we are here to evaluate your institution, understand your plan and level of risk, and assist you in moving through a changing economic world.

Thank You.

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