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SBP Deputy Governor urges banks to follow risk management fundamentals in letter and spirit

Mr.. Yaseen Anwar, Deputy Governor State Bank of Pakistan has said that the current global financial crisis signifies the importance of risk management in financial institutions and urged upon the commercial banks to follow risk management fundamentals in letter and spirit.

Addressing a conference on ‘Effective Risk Management in a Changing Environment’ which was jointly organized by International Finance Corporation (IFC) and the State Bank in Karachi today, Mr.. Anwar said 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,” he said and added in this the most significant lesson that has been 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,” he asserted.

Mr. Anwar highlighted some fundamental principles that form the cornerstone of risk management and said that if these principles are followed in letter and spirit they can shield financial institutions from significant losses. He said these rules are simple and equally applicable on small institutions but simple means these are simple to understand; nevertheless implementing some of these fundamentals can be quite difficult.

Talking about the key principle of governance, Mr. Anwar said that 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.

He said that 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, he added.

However, Mr. Anwar said that 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 (CRO) 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), he added.

He said that 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, he said and added that 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. Similarly, Mr. Anwar said that 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.

Mr. Anwar asserted that a reliable and respected information system is the foundation of risk identification and measurement. He said 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,” he added. He said that besides accurate information and frequent dialogue with business units, institutions need to take into account a few other things while designing and implementing risk measurement systems. He said the risk measures adopted should encompass the whole organization. Risk identified in silos may undermine the enterprise wide risk the overall institution is facing. Similarly, Mr. Anwar said that 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. He said the 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, he added.

Mr. Anwar suggested that 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," he said and added 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.

He said that 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," he said and urged upon the banks not to sit on the bare minimum standards set by SBP but should work on improving their stress test framework.

Talking about liquidity management, Mr. Anwar said the recent liquidity crisis that some banks have witnessed reminds 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," he said and added 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.

"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," he added.

Speaking on the occasion, Mr. James Gohary, IFC Senior Operations Manager for Financial Markets in Middle East and North Africa (MENA), said: "We believe that risk management begins with developing a culture to address business risks. The monitoring role that board members must play is vital to the success of risk management in any Bank. This conference provides the opportunity to exchange views, ideas and solutions to ensure that we are all better prepared going forward."

Mr. Michael Higgins *Principal Banking Specialist IFC MENA shared IFC's analysis of recent financial turmoil in MENA region***.** Ms. Annetta Cortez Managing Director Novantas LLC highlighted measures the risk management function should take to manage risk in financial institutions.

In her concluding remarks Ms. Lubna Farooq, Director, Banking Surveillance Department, SBP summed up the discussion and reiterated the strong emphasis of SBP on developing risk management practices in the banking sector.

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