

# Governance, risk and compliance in banks: transparency in risk management – Pillar 2 as a GRC initiative

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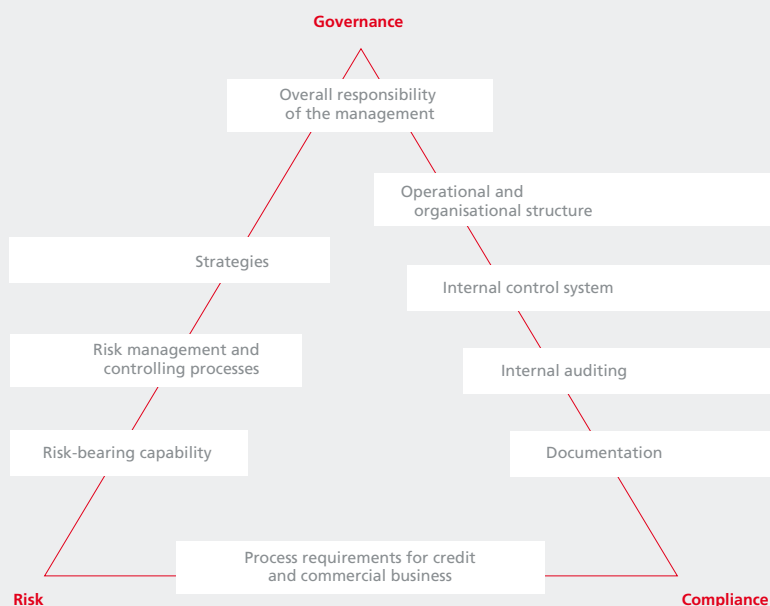
The market players are called upon to assume responsibility for improving risk management. In particular, this concerns liquidity risks, measurement practice, disclosure requirements and transparency.

Prof. Axel A. Weber  
President of the Deutsche Bundesbank

## Banks are able to use implementation of Pillar 2, Basel II, to improve transparency of their internal control and management procedures

In the face of the current financial market crisis, two particular questions come to the fore: namely, how can the supervisory body expedite stabilisation of the financial markets following introduction of Basel II? And what independent action can individual banks take to protect themselves against the potentially catastrophic consequences of such a crisis? These questions also form the subject of recommendations put forward by the Financial Stability Forum (*cf. interview with Prof. Axel A. Weber, President of the Deutsche Bundesbank, p.10*).

In this respect, the interests of supervisory authorities and the individual banks are actually closer than may well appear at first glance. It is less a question of tightening specific regulatory requirements – for one only needs to look at the current crisis to see that the supervisory provisions are lagging behind the financial markets. Rather, it pays to take a closer look at the existing requirements of Pillar 2; given that implementation of these provisions improves transparency in risk management and capital allocation, not only for the supervisory authorities, but also on an internal basis for the banks themselves. Naturally, this does not guarantee strategically correct management decisions; however, it does considerably reduce the likelihood of undesirable developments. As such, implementation of Pillar 2 is not a ‘necessary evil’, rather it represents an opportunity. Thus, the opportunity is not merely a question of using the framework prescribed by Pillar 2 to achieve transparency vis-à-vis supervisory authorities in terms of risk management and capital allocation, but is also about specifically using Pillar 2 internally within the bank to improve management and create a culture of risk awareness. Overall, this is implemented by means of governance, risk and compliance (GRC).



A comprehensive GRC initiative not only enables banks to meet the requirements of Pillar 2, but, above all, also allows them to use the requirements internally to improve management and create a culture of risk awareness.



### Compliance and corporate management must go hand in hand

To date, compliance has frequently been limited to ensuring observance of the requirements of supervisory law, such as sending commensurate reports to the appropriate authorities. The information required to achieve this often stems from technical island solutions – seldom is it the result of a comprehensive overview created, for example, within a management information system. This gives rise to data redundancy and unnecessarily high expense due to the fact that management, internal auditing of the supervisory authority are, in part, presented with similar information. In addition, certain aspects of risk management and compliance are inadequately incorporated within the structure and process organisation of many banks. The outcome: in a number of banks the management and supervisory board have an insufficient overview of the existing risk situation. Whereas risk management and compliance may be somewhat secondary aspects for other companies, in the case of banks, these areas form a central element of the business activity and as a result should be appropriately incorporated into corporate management (governance).

Achieving this first requires 'compliance' to be expanded so that it goes beyond simply referring to reporting. Such expansion entails the introduction of a corresponding framework as well as structural and procedural organisation within the bank. Moreover, activities need to be incorporated into bank management processes to a far greater extent than has previously been the case. Overall, the aim is to bring risk management and compliance in line with corporate objectives and present the management with the information necessary to accomplish this. Only by achieving such a position is it possible to establish the risk-bearing capability, determine a risk strategy and ensure adequate provision for risks and risk situations.

Ralf Huff

### Risk management as a central element

Any comprehensive risk management system within the meaning of a GRC initiative will not only include credit, market and operational risks, but will also extend to an internal system of control. In addition, risks that are somewhat difficult to quantify such as the risk to reputation, strategic risks, or risks not backed by equity, such as liquidity risks, can also be afforded consideration. A GRC initiative will also include commensurate documentation, communication and incorporation into training and personnel development. Not least, it will also require well-grounded and comprehensive IT support.

The benefits of such a GRC initiative considerably outstrip the associated costs. Firstly, costs are reduced through the avoidance of data redundancy; secondly, the costs of implementing Basel II (Pillar 2) are minimised as a result of pre-empting the requirements prescribed by the supervisory authority; and thirdly, the process gives rise to an expectation that financial markets will reward a risk-conscious approach and effective controlling. Indeed, this expectation has encouraged a series of banks to select an advanced approach in terms of calculating equity capital needs.

However, of much greater importance than cost considerations is the opportunity to considerably enhance assessment of the bank's risk position and, consequently, safeguard its sustainable development. This is not only in the interests of the management, supervisory board and investors, but also serves the interests of the financial supervisory authorities.