

TRAINING RESOURCE BOOK

Improving Risk Management and Financial Disclosure Systems under a Good Corporate Governance Framework



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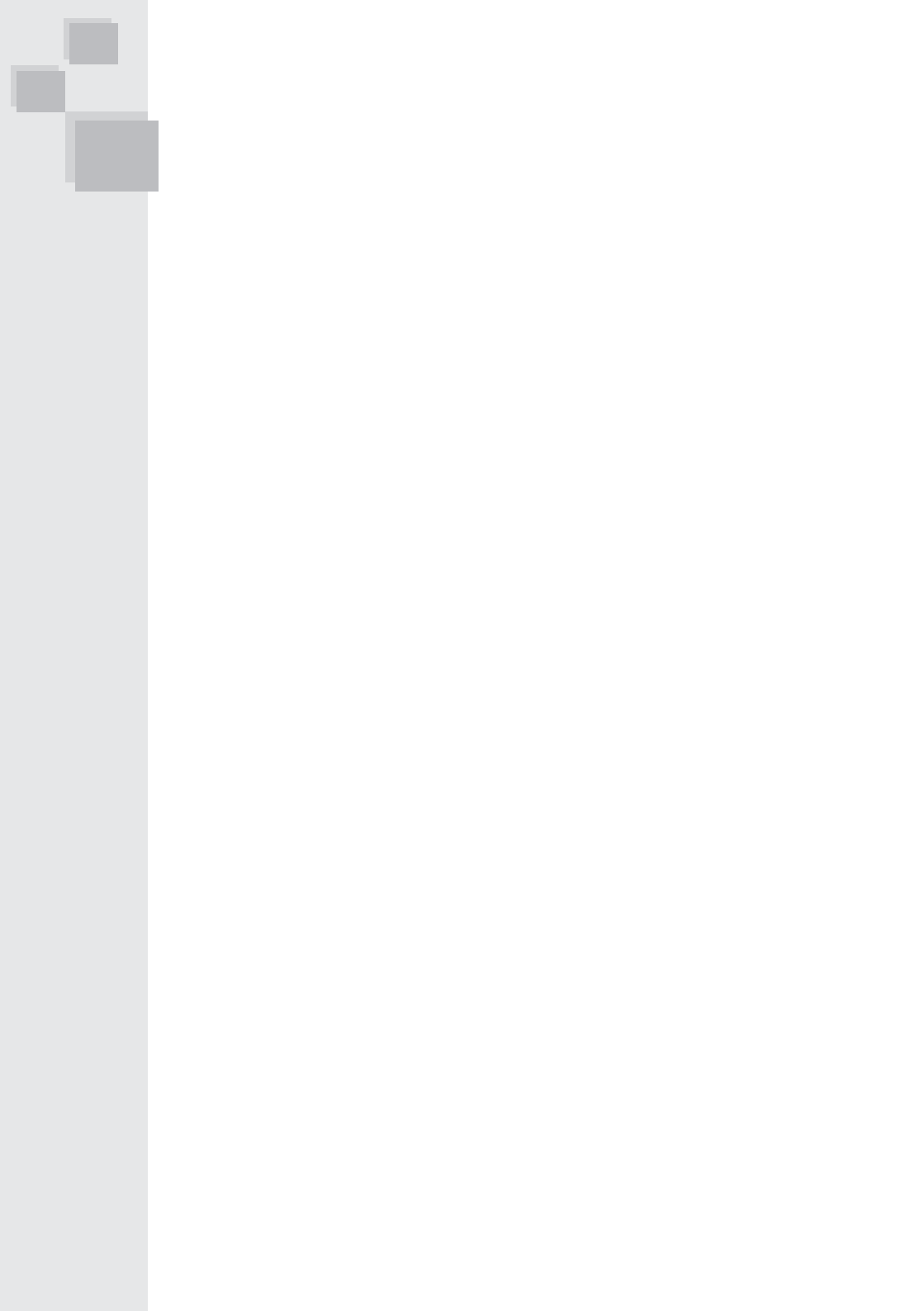
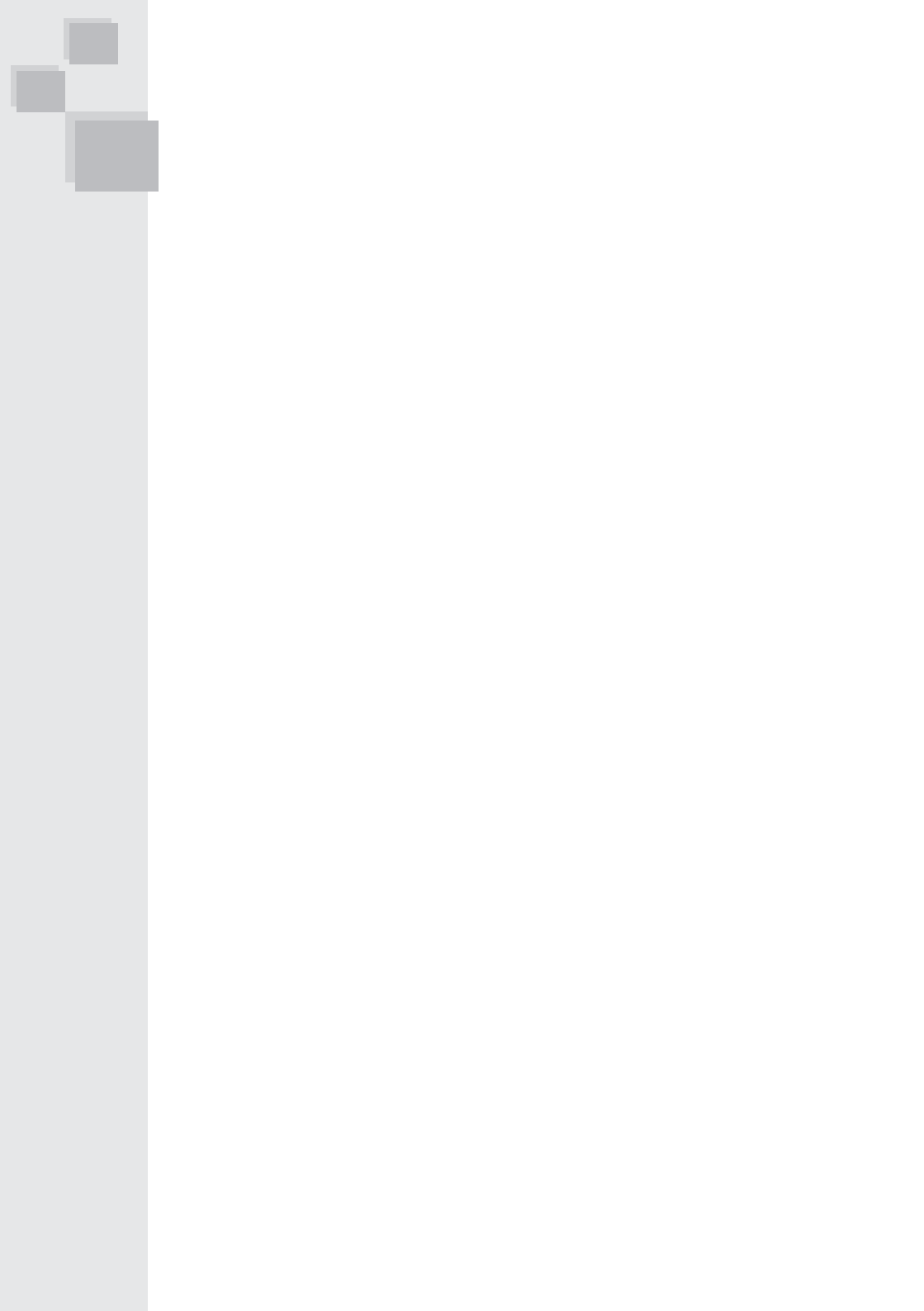


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FOREWORD

*T*his project, *“Improving DFI Risk Management and Financial Disclosure Systems in the Context of Corporate Governance Reforms and International Conventions”*, takes the advocacy of ADFIAP on corporate governance to a new level.

Building on the first four phases of ADFIAP’s integrated *“DFIs for Corporate Governance”* Project, this new project (Phase 5), as in previous project phases, is a capacity-building program for member-banks of ADFIAP. The objective is to strengthen the member-banks’ core business functions of risk management and proper financial disclosure by reinforcing them with strong corporate governance principles. It is an effective segue from the previous project phases that ADFIAP implemented whose accomplished objectives were:

- **Phase 1:** Adoption and documentation of a code of corporate governance by the member-banks’ Board of Directors
- **Phase 2:** Development of a corporate governance rating standard for internal use and assessment of the corporate governance practices of their clients
- **Phase 3:** Development of a corps of Compliance Officers enhancing their scope of work to institute good governance as well and setting up of Compliance Units
- **Phase 4:** Institutionalization of good corporate governance for sustainability practices

After successful runs of one regional (Manila) and four national (India, Malaysia, Vietnam and Papua New Guinea/Pacific) seminar-workshops, this Training Resource Book was prepared to, broadly, institutionalize the learning process and, specifically, to provide the tool kits and reference information that ADFIAP member-banks and other users of the resource book can use and adapt in their




respective context in order to enhance their corporate governance practices.

Based on the course contents of the seminar-workshops, this resource book provides comprehensive and relevant aspects of risk management and disclosure systems under the framework of corporate governance. It is also gratifying to note that implementation of this project, including preparation of this manual, validates the tenet that while there are differences in the structural frameworks among countries, these differences are underpinned by the same and universal principles of good governance.

The first part of this resource book discusses the overview and elements of good corporate governance, emphasizing that the buy-in at all levels of the organization starting from the Board of Directors is critical to its success. The manual then presents the four (4) case studies used during the seminars. The first case study is at a macro level as it is about the 1997 Asian financial crisis. The other two are at the micro or business level as these discuss the experience of a small and medium enterprise (SME) development bank and government pension fund. The fourth case study deals on key performance indicators of State-owned Enterprises (SOEs) as most ADFIAP member-banks are. The resource book's coverage also includes the history of Basel I and II as they impact on the banks' capital structure and various aspects of risk management.

The succeeding parts contain the proposed training program outline and agenda as well as readings, objectives and lessons for each of the training session, complete with suggested Powerpoint slides (in CD format only), case study materials, and practical projects for use of the training resource person in implementing the program. This training guide is also available in CD format (please see attached at the back cover).



ADFIAP takes this opportunity to gratefully acknowledge the **Center for International Private Enterprise** (CIPE) for providing the grant money in making the project and the production of this booklet possible. Special thanks are due to **John D. Sullivan** and **John Callebaut**, CIPE Executive Officer and Senior Program Officer for Asia, respectively, who have given their trust and support to the project.

ADFIAP is also grateful to **Dr. Cesar Saldaña**, Founding Fellow of the Institute of Corporate Directors in the Philippines, who efficiently conducted all the seminar-workshops under this project. His extensive experience in banking and finance is matched only by his passion to teach and share his knowledge.

This training resource book is a product of the dedication and hard work of the ADFIAP Secretariat, the direction and guidance of the Board of Directors, the logistical support of the members who hosted the training events under this project, and the general ADFIAP membership whose insights and interest in the project was inspiring to all.

NOTA BENE

The project – *“Improving DFI Risk Management and Financial Disclosure Systems in the Context of Corporate Governance Reforms and International Conventions”* – under which this Training Resource Book was published, aims to build capacity among members of ADFIAP and to strengthen effective and international standard-based risk management and financial disclosure systems.

The specific objectives of the project were to:

1. support improvements in risk policy, management and practices and their underlying corporate governance structures;
2. improve understanding of financial reporting policies and practices and their role in efficient capital markets;
3. improve the institutional framework of corporate governance reform by ensuring that they enhance risk management and financial reporting in a more transparent and accountable manner and support capacity-building and implementation of recommended improvements; and
4. develop and conduct a training course in effective risk management and financial reporting systems that include case studies illustrating practices in ADFIAP member-DFIs in these two areas.

This Training Resource Book was developed for the conduct of intra-country and intra-DFI seminar on risk management and financial reporting under a framework of good governance. The course program was developed from a process that included the following:

- reviewed prior corporate governance improvement programs under the ADFIAP-CIPE *“DFIs for Corporate Governance”* Project to identify remaining gaps in the areas of risk management and financial reporting;

- developed an initial design of the course to conduct a 5-day Regional Seminar on the above topics;
- invited participation at the Regional Seminar from a cross section of countries where ADFIAP has members in order to get a wide range of feedback;
- conducted the Regional Seminar and got the feedback from participating DFIs about the content and effectiveness of delivery of the course content;
- based on the feedback from the Regional Seminar, developed a two-day program for conduct in selected ADFIAP members' countries; and
- conducted the country seminars under the sponsorship of a DFI member-host institution, ADFIAP and CIPE.

This Training Resource Book was developed to enable trainers, regardless of country and institution to understand what learning points are needed to be delivered during the seminar and the training materials that are relevant to deliver them.

The training values are summarized for the trainer for each presentation and case study, as follows:

- **Summary.** This provides the trainer with concise highlights of the facts and interpretation of the training material and its relationship with the other topics in the seminar.
- **Training Objectives.** This presents the perspectives and improvement goals that the training material is seeking to impress upon the participants, including a change in behavior and specific resolutions to improve corporate governance for risk management and financial reporting.
- **Lessons Learned.** This is a list of possible learning values that can be provided by the training material as part of the benefits of the seminar acquired by each participant.

TYPICAL PROGRAM OUTLINE OF TWO-DAY SEMINAR-WORKSHOP

DAY 1

AM Strengthening Risk Oversight by the Board

Opening Ceremonies

Topics:

- * Overview of Corporate Governance for Bank Directors
- * Role of the Board in Oversight of Bank Risks
- * Case Study of the Asian Financial Crisis of 1997: A Failure of Bank Risk Management

PM Board Policy and Management Control over Key Risk Areas

Topics:

- * History of Basel Accord I & II
- * Hierarchy of Banking Risks
- * Case Study of Business Model Risk in SME Bank "A"

DAY 2

AM Role of the Board Risk Management Committee in Oversight of Bank Risks

Topics:

- * Role of the RMC in Managing Bank Risk
- * Case Study of Operational Risk at a Government Pension Fund

PM Issues of Measurement and Disclosure of Risks and Benefits

Topics:

- * Case Study of Key Performance Indicators for a State-owned Enterprise (SOE) – SME Bank "B"
- * Evaluation
- * Wrap-Up
- * Closing Ceremony

DAY 1 - MORNING

Theme: Strengthening Risk Oversight by the Board

Presentation I: **OVERVIEW OF CORPORATE GOVERNANCE FOR DIRECTORS**

Summary

The elements of good corporate governance (CG) are introduced. The pillars of good CG are sound leadership of the Bank, compliance with regulations, and effective market discipline. The separation of the Board from management provides a balance in setting directions and their implementation. Effective risk management provides the necessary check and balance to the Bank's pursuit of its profits and growth goals. Effective market discipline requires attention to disclosure requirements of investors. Lack of proper disclosures weakens the confidence of investors. There has been major progress in promoting good CG but challenges remain. Major improvements are required for more progress in public disclosure, search for independent Directors, and in improving the technical skills of Directors.


Objectives

The presentation intends to enable the participants to:

- be updated on the current understanding of the pillars of good CG.
- be introduced to the main criteria for good CG for Banks.
- understand that continuing improvements are called for by both regulators and investors in the capital market.

Lessons

At the end of the presentation, participants would have learned the



following lessons:

- Good CG is now a requirement of all Banks. The degree of investor and stakeholders confidence on the Bank depends on it.
- As a Director, one should take active leadership to promote good CG.
- Building skills in such areas as financial reporting and labor regulations is a requirement for Directors if they are to keep abreast of developments in good CG.

Presentation II: ROLE OF THE BOARD IN OVERSIGHT OF BANK RISKS

Summary

The Board has a central role in the oversight of management's risk-taking role. It is the responsibility of the Board to be informed as to the types and degree of exposure of the Bank to risk. The role of the Board in risk oversight involves setting the risk policy. An important role is protecting capital at the Bank level, at the business segment level, and at the transaction level. Since the Board faces a mighty challenge in dealing with risk oversight, there is a need to set up a Risk Oversight Committee (ROC) at the Board level. The ROC gets assistance from Internal Audit at the management level and from the Board Audit Committee. The Board also has the option to mandate adoption of risk management engines (RME) to better guide management on the risks that the Bank is taking.

Objectives

The presentation intends to enable the participants to:

- know the role of the Board in oversight of risk-taking activities of management.
- understand that ultimate responsibility for taking risks rests with the shareholders through the Board.

- introduce the role of RMEs in the management of risk and the assurance to the Board that risk identification, analysis and measurements are in place.

Lessons

At the end of the presentation, participants would have learned the following lessons:


- Ultimate responsibility for risk taking is assigned by law to the Board.
- The Board needs to take an active role in oversight of risk at the risk policy, acceptance of risk at the business segment level, and the pricing of risk at the customer level.
- Adoption of RMEs is conducive to risk identification and measurement but risk-taking still remains the responsibility of the user of the RME.

Case Study I:

THE ASIAN FINANCIAL CRISIS OF 1997: A FAILURE OF BANK RISK MANAGEMENT

Summary

The Asian Financial Crisis of 1997 was called the “first crisis of the globalized world”. Simply, it means that the regional crisis affected the other parts of the world. It showed that financial markets are interconnected and investors are themselves global. The lessons are evident – failures by banks in one country or region caused panic in stock markets in other countries and regions. After an initial panic, the companies and banks affected by the crisis sorted out their financial conditions and prepared themselves for recovery and for some, liquidation. The causes of the crisis are overvalued currencies all over the region and the speculative investments financed by short-term loans from banks. It was called a “double mismatch” – long-term loans were finance by short-term money



and projects that earned local currency income being financed by foreign currency (loans).

The crisis materialized when it became clear that export growth – needed to pay out forex loans – will slow down. At the same time, large investments mainly in the property sector will not payoff due to oversupply. Eventually, local currencies were devalued and excessive investments liquidated with large losses incurred by investors in the region. The role of banks in underwriting the investments and loans of speculative and risky ventures led to the reform movement by regulators and companies for improvement in corporate governance systems. A number of CG regulations and codes of conduct were issued targeting the banks and publicly listed companies.

Objectives

The presentation aims to enable the participants to:

- understand the lessons of the Asian Financial Crisis of 1997.
- understand the new regulations and CG codes that came out in response to weaknesses revealed by the Asian Financial Crisis.
- determine whether similar conditions are present in banks and companies regarding risky mismatches and aggressive risk taking by large shareholder-dominated Boards.

Lessons

At the end of the presentation, participants would have learned the following lessons:

- The rules and regulations have changed toward a more activist role to protect investors and bank depositors.
- A Board Director should have an independent stand on issues facing the Bank rather than blindly following the large shareholder.
- Decisions by company Boards now have to face tougher scrutiny by analysts and investors.

- The global model for good governance is the OECD Code of Governance whose prescriptions are for voluntary adoption, indicating that the market views with favor those who adopt good CG policies.

DAY 1 - AFTERNOON

Theme: Board Policy and Management Control over Key Risk Areas

Presentation III:

HISTORY OF BASEL ACCORDS I AND II

Summary

The presentation entails the evolution of capital regulation from initially crude approaches for limited number of risk factors into more sophisticated risk measurement systems and covering all types of major risk factors. The methods of risk analysis have been refined for market and credit risks but only beginning for operational risk. The accumulation of risk data is given priority in Basel II including the emphasis on operational risk.

Objectives

The presentation intends to enable the participants to:

- know the history of capital provisioning standards that have come to be known as the Basel Accords.
- be introduced to capital provisioning for operational risk.

Lessons

At the end of the presentation, participants would have learned the following lessons:

- Capital requirements are a reality and the standards are global rather than local.
- The scope of the Basel Accords has expanded to cover all major risk factors faced by a Bank, the latest being operational risk.



Presentation IV: **HIERARCHY OF BANKING RISKS**

Summary

All banks face the same set of risks that end up as a charge on capital. Capital is intended to be a buffer against all unexpected losses from all sources of risks to the Bank. This is because all expected losses are supposed to be covered by capital provisions or reserves. The core risks are credit, market, operational, legal and reputation risks. Other risks are associated with these basic risk factors.

Objectives:

The presentation intends to enable the participants to:

- have a common understanding of risk terminologies
- understand the hierarchical nature of financial risks

Lessons


At the end of the presentation, participants would have learned the following lessons:

- While the focus of capital adequacy regulation has been credit risk and market risk, potential losses those risks are bounded. It is operational risk that has no boundary and could bankrupt a bank.
- The Basel Accords standardized the process of identifying and measuring banking risk.

Case Study 2: **SME BANK “A” – MANAGEMENT OF RISK OF LENDING TO SMEs**

Summary


SME Bank “A” is a newly-organized bank servicing the small and medium enterprise (SME) sector of the country. It is owned almost



entirely by the government. Nominally though, private sector banks contributed equity capital when it was set up but with an amount was so small that it probably does not matter to those private investors whether the SME Bank “A” succeeds or not. Corporate governance literature calls them as “free riders”. In addition, the government guarantees all obligations of SME Bank “A”. That means the capital market will not pay attention and, much less, discipline SME Bank “A” for its performance. In fact, as noted in the case, SME Bank “A” received the same credit rating as the government in spite of its poor financial performance. It can be seen that the principles of good corporate governance did not work from Day 1 (2004), setting the stage for its poor performance as a going concern in 2006. Two key principles – shareholders who require a return on their investment and capital market discipline – are absent.

SME Bank “A” suffered large losses in its lending activities. Basically, the surge in lending in 2004-2005 became poor performing in 2006. The Board acknowledged that lending was driven by government policy and SME Bank “A”’s Board allowed the Bank to be used as an instrument of that policy. The Board further acknowledged that loans merely approved without proper evaluation process and system. Incidents of systemic frauds were reported to the Board Audit Committee. So, it was not evident that while the government wanted more lending to SMEs, that SME Bank “A” will, as it did, lend without appropriate processing and risk assessment and suitable mitigants or collateral in the event of default. Proof that the government did not intend such a free and unmitigated outflow of loans is the fact that the entire Board was fired by the government in October 2006.

The road to recovery is not clear for SME Bank “A”. The new Board is pursuing “good corporate governance” as a solution to its problems. The goal of such policy is to make each employee of the Bank a “risk owner”. However, the real problem was risk management and at a more fundamental basis, laying down the foundations in terms of ownership and market discipline. Government should consider



spinning off SME Bank “A” from government line responsibility or some equivalent autonomous structure. Another is to remove the guarantee of the government to obligations of SME Bank “A”. These may call for changes in the by-laws and corporate identity of SME Bank “A”. Only then can the Bank be given a real chance to achieve its goals.

Objectives

The presentation aims to enable the participants to:

- see how corporate governance works in practice;
- appreciate the difficulties of changing existing structures and social cultures with regards to independence of the bank from the government although the government created the bank
- identify critical factors in achieving good corporate governance

Lessons

At the end of the presentation, participants would have learned the following lessons:

- The Board should uphold the sustainability of the Bank rather than be captive by the interest of the government.
- It is best to clarify the mission and goals of the government that should be addressed by the state-owned enterprise (SOE) – in this case, the SME Bank “A”. It is then the task of the SOE Board to determine how to achieve these goals and still be a sustainable institution.
- There would be less pain all around if these questions of government goals and balancing them against sustainability if these were resolved at the start. Because these are fundamental questions, they must be resolved as early as possible.

DAY 2 - MORNING

Theme: Role of the Board Risk Management Committee in Oversight of Bank Risks

Presentation V:

THE ROLE OF THE RMC IN MANAGING BANK RISKS

Summary

The Risk Management Committee (RMC) is created by the Board to assist the Board in its oversight role in the area of risk management. The scope of RMC's work includes all major risk areas.

- For market risk, RMC defines the markets and investment products that the Bank should deal with, recommends risk limits, and assures that the mark-to-market department has staff competence.
- For credit risk, RMC ensures that the Bank has sound credit policies, a thorough credit process, and skilled credit staff. The RMC productively participates in credit committee meetings, recommends limits defined by credit ratings and instruments, and monitors key credit risk areas like defaults, recovery and exposure risks.
- For operational risk, the RMC conducts regular audits of operating procedures, ensures that fraud control systems are in place, imposes position limits for traders, requires a separation of front and back office, and requires employees to know written policies and procedures.

Objectives

The presentation aims to enable the participants to:

- understand the role of the RMC relative to the Board of Directors.
- understand the scope of responsibilities of the RMC in the three main risk areas.

- evaluate the nature of information and Director competence level in order to perform the responsibilities of the RMC.

Lessons

At the end of the presentation, participants would have learned the following lessons:

- The RMC is an extension of the Board and draws its authority from the Board.
- A Bank must work with the RMC to build its control system for the major risk factors.
- A risk database is necessary for the RMC to perform its monitoring role for the Board.

Case Study 3:

OPERATIONAL RISK AT A GOVERNMENT PENSION FUND

Summary

The Government Pension Fund (GPF) is the pension fund of the government employees in the country who are all member of the Fund. One of the services offered by GPF to its members is the salary loan. It is a simple service of granting personal loans to members based not on creditworthiness criteria but strictly on membership eligibility requirements. The standard collateral is the retirement benefits – unpaid salary loans are deducted from retirement pay. In terms of the credit, it is practically risk free but there are two problems. One, the loans are released and collected through government agencies that do not diligently remit to GPF. Second, there are posting errors on the part of GPF because of possible errors in the allocation of loan repayment between principal and interest.

The operational risk creates problems of trust and confidence for GPF members. The solutions are not easy because of the large number of members and agencies involved. Recent

computerization of direct access by members to their accounts (bypassing the agencies) appear to be bearing fruits.

Objectives

The presentation aims to enable the participants to:

- understand the differences between corporate governance for state-owned enterprises (SOEs) and privately-owned companies.
- evaluate the operational risk presented in the case as to its causes and consequences.
- suggest ways of measuring the losses from the specific operational risk and recommend mitigating measures to control the risk.

Lessons

At the end of the presentation, participants would have learned the following lessons:

- SOEs differ from private enterprise governance because of the political factor.
- Accountability is not immediately acted upon in SOEs because it is difficult to identify during the rotation of Presidential appointees.
- Even when the solution to the SOE's operational problem is obvious and easy to institute, it is not easy to make the changes and the SOE leadership does not have the incentive to make the corrective measure for a problem caused by previous Presidential appointees. Meanwhile, it faces political fallouts and is required to explain the problem to the public, if it ever decides to correct the problem.
- Because the ultimate stakeholders of the SOE is the public, there is a serious "free rider" problem and government supervision is necessary to protect the public from having to pay for the operational losses incurred by the SOE.

DAY 2 - AFTERNOON

Theme: Issues of Measurement and Disclosure of Risks and Benefits


Case Study 4:

SME BANK “B” – KEY PERFORMANCE INDICATORS FOR STATE-OWNED ENTERPRISES (SOEs)

Summary:

SME Bank “B” was established by the National Development Bank (NDB) of as a separate entity in 2004. Its mandate is to support the national government plan for growing the small and medium enterprise (SME) sector in the country. It had a business model based on product offerings that are suitable for target SME markets. It also had specific target beneficiaries based on proven business activities of these beneficiaries and relationship in the past.

On its maiden annual report for 2006, the financial results indicated growth in lending to SMEs but also high provision for loan losses. The Board Chairman acknowledged its difficulties in controlling loan losses while growing the loan portfolio. Consequently, it has moved away from direct lending and instead undertook offering advisory services and training to entrepreneurs. It also intensified its collection activities to control loan defaults. Meanwhile, the NDB announced in February 2008 that it was turning over SME Bank “B” to the national government and under the supervision of the Ministry of Finance, effective May 2008. The decision to spin off SME Bank “B” was explained as a positive one for the Bank because it would gain autonomy from NDB whereas the Ministry of Finance will not be involved in day-to-day operations of the Bank. However, SME Bank “B” is more likely to be infused with central government goals for national development. These concerns need to be addressed by identifying key performance indicators for both the financial sustainability and achievement of social and economic goals for SME Bank “B”.



Objectives:

The presentation intends to enable the participants to:

- understand the inherent problem of governance in SOEs because they must address both financial viability and social and economic objectives that private sector banks need not expend resources for.
- evaluate the adequacy of risk management system at SME Bank “B” compared to SME Bank “A”.
- evaluate the financial performance and condition of SME Bank “B” compared to SME Bank “A”.
- recommend key performance indicators for SME Bank “B” concerning its social and economic accomplishments over the period 2004-2006.

Lessons

At the end of the presentation, participants would have learned the following lessons:

- SOE banks should operate within a framework of the balanced scorecard, i.e., a rating system that shows accomplishments in financial, economic and social areas.
- It is not enough that as SOE be given autonomy in making decisions – they should be formally required to achieve social, economic and maybe even environmental targets.
- SOEs have a broad sphere of accountability but smaller capacity to generate their own funds, e.g., both SME Banks are dependent on their respective governments for financing their programs.
- The culture of subsidies is alive and well as demonstrated in the two SME Banks. Corporate governance wants to create value by being a sustainable institution without subsidies.