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BRYAN O'CONNELL HAS A LEAD ROLE IN THE MAGIC FLUTE WITH THE MELBOURNE OPERA COMPANY OPENING 6 NOVEMBER 2003.

# BANKS GET A GRIP ON RISK

**BANKS ARE STARTING TO VIEW RISK MANAGEMENT MUCH MORE SERIOUSLY – AND NOT JUST IN RELATION TO CREDIT RISK. BY BRYAN O'CONNELL.**

Much attention and work has been focused on risk management in Australian banks in recent years, with significant improvement in many risk management practices giving them a leading position compared with their Asia Pacific counterparts.

There is little doubt that risk management has evolved as its own separate and distinct discipline; and as a critical strategic tool in improving performance. Risk assessment is now a standard part of every deal, strategic discussion and financial review.

There have been major improvements to risk management techniques, tools and the way banks are structuring themselves to deal more effectively with the issues. The focus is on credit practices, operating risk, data quality and collection, decision making, people behaviour, legal compliance, regulation and training.

## **Driving the change**

The changed attitude to risk management in Australia can be traced back to the boom and bust of the 1980s, when bad credit practices left many Australian banks with wounds that took a long time to heal. Westpac, in particular almost collapsed under the weight of huge corporate losses in the immediate aftermath. The banks undertook a major reassessment of their credit and lending practices, along with many other management and operational changes. It stimulated significant changes to risk management practices with the process continuing for a number of reasons, including compliance with the Basel Accord.

Fundamentally, we have seen not only a desire of banks to protect themselves from balance sheet deterioration, but equally a push for improved performance by better managing risks and capital.

With banks now more constrained in terms of ways to increase revenue and reduce costs, more attention is focused on how risk and capital management can help the bottom line.

Other global events are at play as well. These include increased financial market volatility, political event risk through increased terrorism, increased regulation and importantly, the effect of the upcoming Basel II reforms.

We have also seen increasing losses due to fraud and security breaches and more attention being paid to technology risk, both internally and in relation to outsourcing.

## **Attention from the top**

Banks have made a number of changes to their risk management structures. The ANZ Bank, for instance, focuses on risk management at the highest levels. Under its risk management framework, the board oversees risk appetite and strategy.

In addition, the bank has a strong framework for developing and maintaining group-wide risk management policies, procedures and systems, overseen by an independent central team of risk professionals reporting directly to chief executive John McFarlane.

The National Australia Bank has also made some major changes to its overall risk management structure, according to head of strategy and projects (risk management), Stephen Campbell.



He says the biggest change for the bank was appointing an executive general manager for risk management Chris Lewis about two years ago, with a focus on global management of risk.

"This role was traditionally covered off by the CFO," Campbell says. "There have also been changes to the reporting arrangements with groups such as credit, legal, corporate and institutional banking and wealth management. There is 'hard line' reporting into the executive general manager for risk, but also 'dotted lines' into the head of those business units. Embedded risk personnel are now also maintained within each of the business units."

The NAB has also changed its approval processes with its so-called risk assessment approval process. Risk issues are identified within the business units, with the risk business partners assessing any changes to existing practice.

How the risk is assessed – high, medium or low – determines the level at which the proposal can be approved. Low assessed risks can be determined within the business unit, while those tagged medium risk go to regional risk management. High-level risks are brought to the attention of the central risk management committee.

### **Credit practices and policies**

Many significant changes have been made in relation to credit practices. Standard & Poor's director financial services ratings Peter Sikora says a major change has been the centralisation of credit risk assessment function and approval processes.

At the same time, he says, there has been an increasing emphasis on the credit role. This has manifested in greater management involvement, more training, more software tools, more analysis and less reliance on subjective judgments.

Credit limits and discretions are now always under review depending on economic cycles. All credit decisions are usually made by way of dual sign-off: a specialised credit person and the responsible person from the business unit.

Banks have also introduced sophisticated scoring systems with more automation in the retail lending process, thus taking the human element – and potential errors of judgment – out of the equation. There has also been an increasing emphasis on industry portfolio management, in which categories such as miners, telcos and manufacturers are allocated a risk grading and overall dollar lending limits.

Because of the small Australian economy, banks have had a high credit concentration in the corporate sector. They have therefore looked at ways of putting in place finite limits, so that large exposures are reassessed. Generally, the focus is on ways of mitigating credit risks while managing the customer relationships. This includes on-selling some of the credit risk, or using credit derivatives.

Banks have developed sophisticated internal risk models for corporate banking. This has evolved from the banks originally using ratings agencies, but then developing the ability to factor in their own internal assessment of transactions and facility structures.

### **Risk versus reward**

Historically, Standard & Poor's Sikora says, banks have accepted cross subsidisation of some of their customer relationships. As a result, they have not charged as much for on balance sheet lending or credit risk. That has now changed and banks are separating the credit function from customer relationship issues.

This risk/reward issue in part relates to the economic capital models developed by the big banks. Within their businesses units, some banks are developing operating risk "score cards", which identify and measure the drivers of operating risk.

Depending on the measurement, this process will determine the level of capital – and thus the cost at which the business unit operates.

### **Basel Accord II**

While complex and difficult to deal with, Australian banks are using the Basel II capital accord to raise the risk management bar even further.

Compared to many other banks in the Asian region, Australian banks are well ahead and leading the charge.

The overall picture is that Basel II has accelerated the need for banks to make their infrastructures more robust, to increase the quality and availability of data and to improve their predictive capabilities.

The carrot is the potential for banks which can demonstrate quality risk management to be allowed a lower capital requirement. In fact, some bankers claim that if they get it right, they may be entitled to reduce their capital by as much as 25 per cent once the accord is implemented. However the regulator, APRA is not so sure (see our special Basel supplement in this issue).

### **Operating risk – a key focus**

While complying with Basel II is a key factor in operating risk management, bankers also are increasingly aware that an operating loss can be extremely costly to the bottom line.

Risk management has therefore evolved from essentially looking at credit risk to embracing market and operational risk. Originally, the scope of banks' operating risk management was limited to their insurance operations, which tended to be very small.

In the late 1990s a more profound appreciation of the issue emerged. To illustrate the change, ANZ Bank executive manager of operational risk, Graham Collier says five years ago there were only four people involved in operational risk at the bank. Now the number stands at more than 60.



## Holistic risk management

The next phase of risk management is around the concept of enterprise risk management according to Collier. This involves creating an integrated risk management approach, combining the disciplines of each risk specialisation to achieve a comprehensive and holistic business risk management capability. Factors such as reputation, business and strategic risk are included in this approach.

## Changing the culture

As with banks around the world, the word "risk" for Australian banks is now a firm reality following the September 11 terrorist attacks. However the process of changing risk management culture must be driven from the top – and there is clear evidence that this is firmly on the agenda of bank chief executives and senior management.

One of the keys to changing behaviour has been to link performance and reward to risk management. A key change now being implemented is that rewards such as bonuses are now being based not only just on sales, but also on the quality of the loans written. Stephen Campbell from the NAB says there is more emphasis on a quality loan book.

"Whilst in the past that may have been 5 per cent of your annual assessment, that has now changed to about 15 to 20 per cent in some cases," he says.

Training is also being used to change behaviour and increase risk management knowledge. ANZ has implemented compulsory training in areas such as trade practices, privacy and occupational health and safety. The bank has developed an e-learning module to facilitate this and has been so successful the bank is selling it to other banks and corporations. The internal web is also used extensively.

Another significant culture change is that risk managers now take on different roles with the business: moving from being "policemen" to being strategic advisors on risk.

The NAB's Campbell says the key today is to look at risk management not as a hurdle, but as a factor which might help the business.

"We can provide assistance and have sliding scale of functions from that of policeman, to guardian, advocate to strategic advisor," he says.

Another important facilitator of change is to make it easier for staff to identify risk and get rid of paper recording – that is, try to create new business systems that record business risk and action plans to mitigate risk.

The NAB has been working on a business risk management system which identifies key risks for their business and records them in a business risk management system – an inventory of risks assessed by the business and recorded by the business units.

The system is updated regularly, with business continuity plans built in. Essentially it is a way of getting consistency across the risk management system of each of the major business systems.

The NAB system has been designed so that people within the business are becoming aware of – and upfront about – the risks they are facing.

## No let-up

Whilst many changes have been made to the banks' risk management in banks, there will be no let-up in their focus and intensity of approach. The aim is not only to protect their businesses from the widening array of risks, but to enhance performance by better managing capital and enhancing risk management techniques. ■

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