

Comment by
Independent Audit Limited
on

Principles for Sound Liquidity Risk Management and Supervision

by the
Basel Committee on Banking Supervision of the
Bank for International Settlements

12 August 2008

EXECUTIVE SUMMARY

Role of the board of directors / workload

- Boards of directors in financial institutions are in danger of being overloaded with tasks, inhibiting their ability to fulfil their primary function of oversight of executive management of risk.

Risk appetite / risk tolerance

- While boards of directors are accountable for definition of risk appetite and risk tolerance, practising directors find these issues problematic, and consider them to be evolving in use in their institutions. Again, boards of directors will require that management prepare and present for review and approval analyses of the firm's risk capacity, risk tolerance and risk appetite.
- Principle 2 should **emphasise** the role of the board of directors in relation to **review and approval** of analyses of the firm's risk capacity, risk tolerance and risk appetite, which will have been prepared by the firm's strategy and risk management functions.

Behavioural aspects of risk management

- Executives and managers have a responsibility to manage behaviours effectively, including effective communication of behavioural expectations periodic observation and assessment of behaviour, and enforcement against transgressions. These actions are an essential element of effective governance.
- The liquidity paper would be enhanced by a discussion of the importance of **behaviour** in the firm supporting the firm's risk management efforts within and across the firm; *see more detailed statement of recommendations at para. 29.*
- We encourage BCBS to enhance its discussion of the role of management behaviour in effective liquidity risk management.

Responsibilities of boards of directors

- We encourage BCBS to incorporate as guidance an attachment to its statement of principles a minimum statement of expectations of boards of directors in relation to liquidity risk management.

Principle 4

- We encourage BCBS to reposition Principle 4 in the section 'Management and measurement of liquidity risk' rather than in 'Governance of liquidity risk management'.

INTRODUCTION

1. This note comments on the Bank of International Settlements' (BIS) Basel Committee on Banking Supervision (BCBS) paper *Principles for Sound Liquidity Risk Management and Supervision* ('the BCBS paper').
2. In this note, we focus on BCBS' recommendations and observations in relation to the roles and responsibilities of **boards of directors** and **governance**.

BACKGROUND ON INDEPENDENT AUDIT LIMITED

3. Independent Audit Limited is a specialist advisory firm based in London. We advise major companies in all sectors on their corporate governance and related business practices. We work with a range of FTSE 350 financial institutions, as well as other major financial institutions, in these areas.
4. In addition, we seek to contribute actively, concisely and constructively to the debate in regulatory and professional circles on issues of corporate governance and related topics of risk management, internal control and compliance. Our experience in working with boards of directors, their committees and executives makes us ideally placed to contribute to regulatory and professional debates these issues, where often the vital perspective of boards of directors is not fully considered.
5. Our objective in presenting this response to the BCBS paper is to raise issues of interest and relevance to board directors and therefore to their contribution to the financial institutions on whose boards they serve.

RESPONSE TO BCBS' PRINCIPLES FOR SOUND LIQUIDITY RISK MANAGEMENT & SUPERVISION

6. The problems experienced by many firms since mid-2007 have their external origins in liquidity constraints in the wholesale funding market. As BCBS notes (para 2):

The market turmoil that began in mid-2007 re-emphasised the importance of liquidity to the functioning of financial markets and the banking sector. In advance of the turmoil, asset markets were buoyant and funding was readily available at low cost. The reversal in market conditions illustrated how quickly liquidity can evaporate and that illiquidity can last for an extended period of time. The banking system came under severe stress, which necessitated central bank action to support both the functioning of money markets and, in a few cases, individual institutions.

7. The regulatory and supervisory response has been a plethora of reports on liquidity risk and liquidity risk management. Yet, while the extent of liquidity concerns may be new, the recognition of liquidity risk as a critical aspect of firm risk attention is not. For example, liquidity risk management is specifically identified in Annex V of European Commission

Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (part of the capital requirements directives).

8. The principles stated in the BCBS paper advocate a range of specific responsibilities on boards of directors in relation to liquidity risk. We presume these principles, especially those relating to 'governance of liquidity management' (principles 2 to 4) and others relating to the roles and responsibilities of boards of directors, should be read and interpreted in conjunction with BCBS' paper *Enhancing corporate governance for banking organisations* (February 2006).
9. Taken together, we believe BCBS has outlined a cogent and coherent framework for corporate governance in banking organisations, and that the principles in BCBS' liquidity paper are consistent with, and add texture to, your earlier corporate governance paper. However, there are several areas in which greater clarity or consistency would be useful. We wish to raise these for BCBS' consideration.

Non-executive directors' workload

10. The role and responsibilities of boards of directors are significant, complex and increasingly onerous. Where there is a unitary board structure, responsibility for independent board-level review of risk-related issues commonly falls to the independent, non-executive directors. These directors are, almost by definition, part-time.
11. Many of Europe's larger financial institutions are listed (or joint-listed) in the UK. Recently, Independent Audit Limited hosted a private discussion for chairs of audit committees of major financial institutions. The attendees represented over 30% of the value by market capitalisation of UK and international banking and insurance companies listed on the main board of the London Stock Exchange. The purpose of the meeting was to discuss pressures facing audit committees in such institutions, and to allow these senior non-executives to share knowledge and leading practices.
12. In the discussion, a common theme emerged: that audit committees were responsible (in most of the firms represented) to oversee the institution's risk management, and that the task is a very demanding one. Participants expressed concern about the potentially endless scope of the risk responsibilities of audit / risk committee membership, and how to keep the tasks down to "manageable proportions".
13. In its governance paper, BCBS (at para 24) notes that risk committees are becoming increasingly common:

Among the other specialised committees that have become increasingly common are the following:

Risk management committee - providing oversight of senior management's activities in managing credit, market, liquidity, operational, compliance, reputational and other risks of the bank.

...

although the nomenclature ('risk **management** committee' rather than 'risk committee' or 'risk oversight committee') is potentially confusing in terms of role and focus.

14. Our principal concern is that new, specific demands relating to liquidity risk are being heaped upon non-executive directors whose time is already heavily stretched. We do not mean to suggest that effective management of liquidity risk is not critical to the sustainable performance and sometimes the survival of the banking firm; rather that it is one of the spread of risk classes and risk management issues to which the board of directors (perhaps through delegated committees) must pay attention. We believe it would be better cast as such, since threats to the firm's survival may come from any risk class.

Risk tolerance

15. First, BCBS' 2006 governance paper does not use the normative term 'risk tolerance', relying instead on the more descriptive term 'risk profile'. The 2008 liquidity paper uses the phrase 'risk tolerance' 21 times, including repeated references under the heading of 'governance of liquidity management. Principle 2, for example, states:

Principle 2

A bank should clearly articulate a liquidity risk tolerance that is appropriate for its business strategy and its role in the financial system.

16. As the BCBS paper notes under Principle 2 (at para 10):

A bank should set a liquidity risk tolerance in light of its business objectives, strategic direction and overall risk appetite. The board of directors is ultimately responsible for the liquidity risk assumed by the bank and the manner in which this risk is managed and therefore should establish the bank's liquidity risk tolerance.

17. This statement requires boards of directors to understand both 'risk tolerance' and 'risk appetite'.
18. At Independent Audit Limited's meeting of major financial institutions' audit committee chairs, the issue of risk appetite (or tolerance) was singled out for attention. Participants considered the concept to be complex and difficult to define and use, and that it continues to evolve in use in their institutions. The BCBS' paper treats risk tolerance as a purely quantifiable issue, and, in probabilistic terms (assuming adequate knowledge and information), it can be. However, the issue can also be approached from a different perspective, such as that referred to in the Senior Supervisors' Group (SSG) report on risk management practices:

How senior management at various firms approached the current market turmoil appears to have differed in a number of important ways that help to explain firms' outcomes through year-end 2007. Four such differences in approaches included the following *[inter alia]* :

- the balance that each firm's senior management in general achieved between its desire to do business and its appetite for risk as reflected in the tone set for developing or enforcing controls on the resulting risks¹

¹ Senior Supervisors' Group, *Observations on Risk Management Practices during the Recent Market Turbulence*, March 6, 2008 p.7

19. By highlighting risk tolerance or appetite as being reflected “in the tone set for developing or enforcing controls on the (sic) risks” resulting from firms’ business activities, SSG identifies the importance of both quantitative or technical risk management and **behavioural** aspects of fostering an environment of control. We believe that acknowledgement of this point and its implications for setting behaviour expectations within firms would strengthen the BCBS proposals.

Clarity of board and executive responsibilities

20. Participants at Independent Audit Limited’s meeting of major financial institutions’ audit committee chairs noted that it is essential to maintain a clear distinction between risk oversight (a board responsibility) and risk management (an executive responsibility).
21. From your corporate governance paper, we wish to highlight the following extract:

Principle 1

Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.

17. The board of directors is ultimately responsible for the operations and financial soundness of the bank. While not intended to be a “checklist” of requirements, the Committee has observed that boards of directors and their individual members strengthen the corporate governance of a bank when they do the following *[inter alia]*:

- Understand and execute their oversight role, including understanding the bank’s **risk profile** (emphasis added);
- Approve the overall business strategy of the bank, including approval of the overall risk policy and risk management procedures; . . .
- Develop and maintain an appropriate level of expertise as the bank grows in size and complexity; . . .
- Provide oversight of the senior management of the bank by exercising their duty and authority to question and insist upon straightforward explanations from management, and receive on a timely basis sufficient information to judge the performance of management; . . .
- Avoid participation as the board of directors in day-to-day management of the bank; . . .

These statements are, largely, supported by the principles in BCBS’ liquidity paper.

22. The Institute for International Finance highlights this distinction and its recommendations on liquidity. It recommends² (Recommendation 4) that the board (or a committee thereof under delegated authority) . . .
- a. **approve and review annually:**
- the strategy and significant policies related to the management of funding liquidity risk under both normal and stressed conditions;

² Institute for International Finance (March 2007), Principles of Liquidity Risk Management, p.20

- b. **approve documents** which:
 - identify key funding liquidity limits and approval levels, as well as those authorities delegated to senior management committees or those executives accountable for approving detailed strategies, goals, procedures, limits, and exceptions;
- c. on an **on-going basis**:
 - ensure that senior management takes necessary steps to appropriately manage, measure, monitor, and control funding liquidity risk in an integrated fashion with other closely associated risks to facilitate enterprise-wide risk-management solutions;
 - be informed regularly [by executive management] of the funding liquidity position of the firm (metrics, indicators, and outlooks); and
 - be (sic) notified immediately [by executive management] if there are any material changes in the firm's current or prospective funding liquidity positions.

This set of recommendations both clarifies the respective roles of the board of directors and management, and makes explicit the oversight focus of the board.

- 23. BCBS makes a similar distinction. This distinction, between risk management and risk oversight, is helpful. In its liquidity paper, BCBS states:

Principle 3

Senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure that the bank maintains sufficient liquidity. Senior management should continuously review information on the bank's liquidity developments and report to the board of directors on a regular basis. A bank's board of directors should review and approve the strategy, policies and practices related to the management of liquidity at least annually and ensure that senior management manages liquidity risk effectively.

- 24. To provide additional clarity, we have attempted, in Attachment 1, to summarise BCBS' statements on the responsibilities of boards of directors in relation to management and oversight of liquidity risk. We believe such a summary would be a useful addition to BCBS' paper on liquidity.

Behavioural aspects of risk management

- 25. As we state at para 9, above, we view the BCBS paper as presenting a cogent and coherent framework for corporate governance, which has flowed in to your paper on liquidity risk. BCBS has taken a leading role in clarifying the roles of boards of directors in effective bank governance.
- 26. The framework of specification of risk tolerance, requirements for periodic review of policies, review of limit breaches, review of contingency plans, and involvement in increased monitoring during periods of stress, presents a sound and balanced approach to the contribution of a board of directors to the effective risk control environment of a bank. We believe that the behavioural contribution of these board (or board committee) roles, especially

relating to on-going oversight, should be made explicit in BCBS' discussion of governance as forming a coherent cycle of activities which, **collectively**, will support effective risk control.

27. There is limited comment in the BCBS' paper on behaviour of business and support function managers, which contrasts with the critical role of individuals' and groups' behaviour in managing risks of any class, including liquidity.
28. As an empirically-based review by key supervisors of market-leading firms, the SSG report should carry considerable weight. While the report does not address liquidity risk in isolation, many of its observations cover the role of behaviour, and the contrast in behaviour between well-performing and less well-performing firms within its supervisory ambit. The following points are, in part, drawn from that report.
29. We recommend to BCBS that it consider more fully the following issues:
 - 29.1. The importance of a "continuous dialogue" between business areas and risk management functions on whether the firm is balancing appropriately its risk appetite and risk controls;
 - 29.2. The essential role of observation and enforcement of balance-sheet and off-balance-sheet limits in ensuring the integrity and comprehensiveness of the picture of the firm of the risks it holds, and of its understanding of those risks;
 - 29.3. The contribution of challenge by senior management of assumptions regarding risks;
 - 29.4. The utility of involvement of senior managers in understanding and responding to emerging risks;
 - 29.5. The requirement for adequate skill in senior management to review and challenge a full range risks, "since the source of the next disruption is impossible to predict"³;
 - 29.6. The utility of forums, which include business line leaders, to discuss all significant risk exposures across the firm which meet on a frequent basis;
 - 29.7. The need for timely provision of accurate and comprehensive information to senior management;
 - 29.8. The benefits of creating an environment in which business and risk managers can escalate concerns about emerging risks to senior business and risk officers;
 - 29.9. The dangers of formalized, hierarchical structures will serve to filter, delay or distort information provided to senior management;
 - 29.10. The benefits of sharing risk information across business lines as well as within hierarchies or silos;
 - 29.11. The imperative of business areas viewing risk management and risk control functions as integral to effective management and business performance.
30. Governance is critically dependent on the people who effect it, and the impact (or effectiveness) of their actions and interactions with others. We believe addressing explicitly this behavioural aspect of governance is vital to organisations achieving effective internal control, and contributes to what is often referred to as the 'control culture' of the firm, or its 'risk culture'.

³

SSG, p.8

31. Organisational culture (and 'control culture' and 'risk culture') cannot be developed mechanistically or deterministically. It emerges principally from the observed actions, behaviours, rewards and sanctions espoused, enacted and enforced by senior personnel. Executives and managers have a responsibility to encourage behaviours that will be consistent with (i) effective identification, consideration and management of risk and (ii) robust internal control (as defined elsewhere). Management actions should include effective communication of behavioural expectations, periodic observation and assessment of behaviour, and enforcement against transgressions of those expectations.
32. Few of these more behavioural issues of risk management come through explicitly in the BCBS draft principles. However, they are likely to determine both the influence and the efficacy of risk management and risk control functions across all risk classes, including liquidity risk. We encourage additional comment thereon by BCBS in its statement of principles.

Principle 4

33. We question the fit of Principle 4 under the title of 'Governance of liquidity risk management'. Principles 2 and 3 relate to the respective roles of the board of directors and senior management, and thus relate to 'governance'; Principle 4 does not. We recommend that it be moved to the following section of the document.

ATTACHMENT 1

EXPECTATIONS OF BOARDS OF DIRECTORS

PARA.	REQUIREMENT	FOCUS	ROLE	ACTION
132	Recognition of role		The board of directors [should] take full responsibility for the sound management of liquidity risk.	Supervisory review
10	Approvals	Tolerances	The board of directors is ultimately responsible for the liquidity risk assumed by the bank and the manner in which this risk is managed and therefore should establish the bank's liquidity risk tolerance.	Review & approval
11		Strategy & policies	A bank's board of directors should approve the strategy and critical policies and practices and review them at least annually.	Review & approval
119		Contingency funding plan	Approve the contingency funding plan. Senior management should review and update the CFP at least every year for the board's approval, or more often as business or market circumstances change.	Review & approval
11	Establishment of operating conditions	Competencies	The board should also ensure that senior management and appropriate personnel have the necessary expertise and systems to measure and monitor all sources of liquidity risk.	Specification of expectations

PARA.	REQUIREMENT	FOCUS	ROLE	ACTION
55	Establishment of operating conditions <i>continued</i>	Agreement with board of reporting requirements	To facilitate liquidity risk monitoring, senior management should agree on a set of reporting criteria, specifying the scope, manner and frequency of reporting for various recipients (including the board) and the parties responsible for preparing the reports.	Specification of expectations
55		Setting of criteria for escalation of liquidity breaches	Breaches in liquidity risk limits should be reported and thresholds and reporting guidelines should be specified [by senior management and agreed by the board] for escalation to higher levels of management, the board and supervisory authorities.	Specification of expectations
106		Application of stress tests	Stress test results and vulnerabilities and any resulting actions should be reported to and discussed with the board and the bank's supervisors. . . . The results of the stress tests should be explicitly considered in the setting of internal limits . (emphasis added)	Consideration & review
107		Contingency funding plan	Management should consider whether to adjust its liquidity position or to bolster the bank's contingency plan in consultation with the board.	Consideration & review
134		Use test	The board [should] use the results of stress tests, [and] take specific and meaningful actions to mitigate vulnerabilities exposed by stress tests.	Supervisory review
11	Oversight of management actions	Strategy and operating standards	The board should ensure that senior management translates the strategy into clear guidance and operating standards (eg in the form of policies, controls or procedures).	Follow-up & validation

PARA.	REQUIREMENT	FOCUS	ROLE	ACTION
18	Oversight of management actions <i>continued</i>	Follow-up / remedial action	The board should ensure that senior management takes appropriate remedial actions to address its concerns. These may, for example, include • increasing funding costs or concentrations, • the growing size of a funding gap, • the drying up of alternative sources of liquidity, material and/or • [material or] persistent breaches of limits, (emphasis added) • or a significant decline in the cushion of unencumbered, highly liquid assets.	Follow-up & validation
132		Adequacy of oversight	Whether the board provides of adequate sufficient oversight and guidance to line management and staff.	Supervisory review
Prin 3	Oversight of operating activity & reporting	Oversight responsibility	A bank's board of directors ensure that senior management manages liquidity risk effectively.	On-going oversight
13		Monitoring & responding	Receiving reporting from the group's senior management as appropriate that management is actively monitoring liquidity and liquidity risk and quickly responding to all material developments across the group	On-going oversight
18			The board should review regular reports on the liquidity position of the bank.	On-going oversight

PARA.	REQUIREMENT	FOCUS	ROLE	ACTION
18	Oversight of operating activity & reporting		The board should be informed immediately of new or emerging liquidity concerns. These include • increasing funding costs or concentrations, • the growing size of a funding gap, • the drying up of alternative sources of liquidity, material and/or • [material or] persistent breaches of limits, (emphasis added) • or a significant decline in the cushion of unencumbered, highly liquid assets.	Consideration & discussion of options
Prin 3	Review		A bank's board of directors should review the strategy and critical policies and practices at least annually.	Review & approval
14	Knowledge requirements of the board		The board should have a thorough understanding of the close links between funding liquidity risk and market liquidity risk, as well as how other risks, including credit, market, operational and reputation risks affect the bank's overall liquidity risk strategy.	Periodic self-assessment
144	Response to crisis		The nature and frequency of communication among stakeholders [including with the board of directors] should intensify during times of firm-specific or market-wide stress,	