Loi M Bakani: Effective compliance, risk mitigation and control

Speech by Mr Loi M Bakani, Governor of the Bank of Papua New Guinea, at the Institute of Banking and Business Management (IBBM) seminar on “Risk management”, Port Moresby, 4 July 2012.

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Regulation and prudential supervision of banks

The Bank of Papua New Guinea (BPNG) has regulatory and Supervisory powers and duties over commercial banks under the Central Banking Act 2000 (CBA) and the Banks and Financial Institutions Act 2000 (BFIA). Prudential supervision is conducted through on-site inspections and off-site monitoring and involves licensing and policy work as well as enforcement and compliance. The BFIA gives powers to the BPNG to issue prudential standards or directives on matters relating to the supervision of banks. The Central Bank is also the regulator and supervisor of the Superannuation and Life Insurance industries, savings and loan societies and micro-banks. In short, we supervise almost the whole financial system, except for the general insurance industry. My presentation however will focus only on the deposit taking institutions.

Risk based supervision

In recent years, BPNG has shifted away from the traditional rule based approach to regulation and supervision, and has adopted a risk-based approach, which is more risk focused. The Bank recognises that supervisory practice is not a one size fits all approach; instead institutions should be regulated and supervised based on their systemic importance. In this regard, the Bank considers that regulation should be proportional to the systemic importance of the financial institution. For instance, savings and loans societies and micro-banks are tier III institutions that play a key role in providing financial services for the unbanked population. As the risks undertaken by these institutions are high, they should have significant corporate governance, capital adequacy, liquidity, operations and credit risk issues.

The Bank has taken a deliberate approach to providing an advocacy and promotional role in working together with these institutions to promote the growth of financial intermediation in the monetisation of the economy that in turn ensures financial system stability and promotes economic growth.

Risk and risk management

Risks are inter-dependent and events affecting one area of risk can give rise to other categories of risk. From a regulators perspective, the most important thing is to understand the risks forced by the banks and to ensure that the risks are properly assessed, effectively controlled and managed. The risk profile of a bank changes every time a new business venture is undertaken.

Risk Management is a discipline at the core of every bank and encompasses all the activities that affect its risk profile. Banks in PNG can introduce risks into their operations through imprudent management practices. These include credit, operations and market risks.

It is pleasing to note that banks in PNG are risk aware and have put in place necessary risk mitigation controls depending on their respective risk appetite. Banks have generally achieved the various stages of defining, implementing and enforcing some risk framework to ensure that it is commensurate with the scope and complexity of its operations.

I will now briefly touch on key risk areas that BPNG focuses on in its reviews of the banks.

Capital risk

BPNG emphasizes that it is the responsibility of an institution's Board and senior management to ensure that the capital resources are appropriate to the size, business mix and complexity of the institution's business. Accordingly, the institution must have suitable systems in place to identify, manage and monitor the risks associated with its business activities, and to hold a level of capital that is commensurate with its overall risk profile.

In controlling capital risk in the banking system, BPNG has put in place requirements in the form of the Capital Adequacy prudential standard. The standard incorporates the minimum Capital Requirements as stated under the BASEL 1 Accord.

BPNG has set the minimum capital ratios of an institution at 6% (leverage ratio), 8% (Tier 1 Risk Based Capital) and 12% (Total Risk Based Capital). Institutions are expected to have adequate buffers above the BPNG minimum capital ratio. This may range from several percentage points for the smaller unsophisticated institutions to small margins for the larger institutions with sophisticated capital management systems.

Excessive leverage by banks is widely believed to have contributed to the recent global financial crisis. To address this, the international community has proposed the adoption of a non-risk-based capital measure, the leverage ratio, as an additional prudential tool to complement minimum capital adequacy requirements. Its adoption can reduce the risk of excessive leverage building up in individual entities and in the financial system as a whole.

It is pleasing to note that BPNG is one step ahead as the Leverage Ratio forms part of our minimum capital requirements.

Adherence to these minimum standards has been a norm by the banking system and BPNG has not experienced any adverse effects regarding capital run by the regulated institutions.

As at end of March 2012, the banks maintained adequate capital levels despite a general decrease in their indicator ratios. Total capital to Risk Weighted Assets (RWA) increased to 30.2 percent as at end of March 2012 from 28.0 percent at the end of December 2011. Total Capital as a percent of total assets increased to 12.3 percent from 11.2, while Tier 1 Capital to RWA increased to 23.2 percent from 20.2 percent over the same period.

Board and management risk

BPNG emphasizes that the Board is ultimately responsible for employing the right persons in management positions and ensuring that the business functions and their risks are managed in line with Board expectations and in such a way that also serves the interest of stakeholders. Much can be gained by understanding the key players in charge of running the operations, their roles and responsibilities and who they report to.

The Senior and Business Line Management structure should be sufficiently resourced. The number of senior positions should be commensurate with the responsibility and be proportionate to the size and risk profile of the institution, taking into account outsourced functions. This is often a problematic area for smaller institutions that may find it difficult to attract sufficiently skilled personnel for management role.

There should be regular review of the overall management structure to ensure the structure continues to reflect the dynamic needs of the regulated institution, for example, management requirements may shift over time due to changes in risk profile.

The general criterion for the selection of management team includes the following but not limited to:

1. The "Fit and Proper" Test;
2. Conflict of Interest must be avoided especially when one person is performing two roles;

3. Key Persons Risk must be avoided; and

4. Remuneration must be clearly defined to control the high turnover rate in management.

Apart from the ongoing minor issues that the BPNG has with the Boards and management of the regulated institutions which can be corrected in the normal course of business, the notable issues that require supervisory action have been addressed in the strictest manner, consistent with the prudential standards to mitigate any risk on the financial system.

Governance risk

The Board and senior management of the supervised banks are expected to promote and demonstrate an organisational culture that expects integrity from all employees in conducting the institution's business and a sound and prudent approach to risk identification and management.

The Board has primary responsibility for the management of risks faced by the institution. This includes involvement of the Board in the development of the Risk Management Framework (RMF) and how the Board is provided with the assurance that the RMF is being followed.

The RMF is not one discrete policy, strategy or document. Rather it comprises the totality of all of the structures, policies, strategies and procedures that exist in relation to risk management.

The RMFs should provide the Board and BPNG with reasonable assurance that an institution's business is appropriately controlled, and that its risks are being prudently and soundly managed.

BPNG emphasis that the responsibility of an institution's Board and management is to ensure that the institution meets prudential and statutory requirements and has management practices to limit risks to prudent levels. BPNG has noted that the current risk governance practice by each regulated institution is satisfactory. For example, it is noted that the role of the Board in risk management has now evolved from pure oversight to active participation in defining risk appetite, and approving the broad risk parameters for the organization.

Strategy and planning risk

BPNG assess the strategy and planning process of the supervised institution's strategic risks and its approach to business planning and strategy implementation.

- The institution's strategic positioning is generally assessed based on, but not limited to:
- the market that the institution operates in;
- its competitors and their competitive advantage;
- the number of competitors in that space;
- cost management (margins);
- maturity of the industry, homogenous nature of the industry; and
- diversification of the business and geographic footprint.

BPNG assess the bank's key value proposition - where the bank is adding value and the key drivers of its business - in order to understand where the bank is positioning itself strategically. This should also give some indication of the viability of the bank. BPNG can consider whether the bank is capable of achieving its objectives (based on market conditions, its historical performance, leadership and culture, etc).

From BPNG's perspective, it appears that the banks' strategies are based on the risk tolerance of their sizes and product mix as well as their target market.

Liquidity risk

One of BPNG's objectives is to ensure that all banks have sufficient liquidity to meet obligations as they fall due across a wide range of operating circumstances. Institutions are particularly vulnerable to sudden and unexpected demand for funds, which may have significant implications for other institutions and for the financial system as a whole.

The onus is on the Board to ensure that they are apprised for key liquidity risk issues arising within the bank and that these are well understood and addressed in a timely manner. It is their responsibility to understand the nature, complexities and level of liquidity risk assumed by the bank, including the tools used to manage liquidity risk through the establishment of a prudent liquidity management framework. The liquidity management framework involves policies (approved by the Board), systems, reporting and other processes which should be documented in the liquidity policy.

Currently the banks are very liquid. The ratio of liquid assets to total deposits increased to 73.9 percent as at March 2012 compared to 73.2 percent in December 2011. Total loans to total deposits decreased to 46.9 percent at end-March 2012 from 48.3 percent in December 2011. The ratios indicate that the system is sound as there are sufficient liquid assets to continue lending activities, pay customer withdrawals and meet short-term obligations in the normal course of business. As the system is highly liquid the BPNG cash reserve requirement (CRR) is at 8.0 percent.

Operational risk

The Basel Committee on Banking Supervision recognizes that the exact approach for operational risk management chosen by an individual bank will depend on a range of factors, including its size, sophistication, nature and complexity of its activities. Whatever these differences are, clear strategies and oversight by the Board of Directors and senior management, a strong internal control culture (including clear lines of responsibility and segregation of duties), effective internal reporting, and contingency planning are all crucial elements of an effective operational risk management framework for banks. Operational risk is a term that has a variety of meanings within the industry, and therefore for internal purposes, banks may choose to adopt their own definitions of operational risk. Whatever the exact definition, a clear understanding by banks of what is meant by operational risk is critical to the effective management and control of this risk category. It is also important that the definition considers the full range of material operational risks facing the bank and captures the most significant causes of severe operational losses.

BPNG through its on-site supervision is satisfied that individual institutions are managing operational risk at a satisfactory level.

Credit risk

The primary concern for BPNG under credit risk is non performing loans (NPLs). An institution will always have some "bad" loans.

It is the responsibility of the Board to ensure that it puts in place a Credit Risk Management Framework (CRMF). The CRMF for an institution is the totality of the policies, procedures, systems, models, methodologies, and delegations that govern the way credit risk is managed. All these processes put together, can be described as the credit risk 'architecture' of the institution. For the PNG banks, credit risk is mostly associated with their lending transactions.

BPNG has in place a prudential standard on asset quality which is titled Asset Classification, Provisioning and Suspension of Interest. This standard is intended to ensure that: (i) loans and advances are regularly evaluated using an objective grading system that is consistent with regulatory standards; (ii) the accounting treatment for accrued but uncollected interest on non-performing assets is consistent with international accounting standards and regulatory reporting requirements; and (iii) timely and appropriate provisions and write-offs are made to the loan loss provisions account in order to accurately reflect the condition and operations of the bank. It is also intended to promote well-reasoned, effective work-out plans for problem assets, and effective internal controls to manage the level of such assets.

As at end June 2011, Asset Quality of the banks was maintained at satisfactory levels. NPLs to total assets marginally decreased to 1.0 percent as at end-June 2011 compared to 1.1 percent at end-March 2011. Provision for loan losses to NPLs decreased to 188.8 percent from 121.0 percent over the same period, while NPLs to total loans increased to 5.5 percent from 2.4 percent.

Market risk

Institutions must put in place a market risk management framework that should outline the policy and process on measuring, monitoring, managing liquidity, interest rate, foreign exchange and equity as well as commodity risk.

BPNG has in place a prudential standard for foreign exchange risk called Foreign Currency Exposure Limit. This standard is intended to: 1) assure that the potential risk of loss to a bank's capital base is within prudential limits; 2) promote maximum availability of foreign exchange at competitive rates; and 3) allow banks to conduct business in a profitable yet prudent manner.

Apart from minor issues with the banks regarding adherence to the requirements of the prudential standard, it is pleasing to note that the banks are managing market risk adequately.

Challenges in risk regulation and compliance in banks

In summary, and as mentioned in each of the risk areas, the following are the challenges we face at BPNG regarding supervision of risks and compliance by banks:

- The financial market is thin and therefore raising capital domestically is not easy;
- Funding is based on domestic deposits and there is limited wholesale or external funding. The absence of an effective secondary market for government securities, coupled with deposit funding that has some concentrations and a limited retail component, requires banks to manage their liquidity more stringently;
- Technological innovations giving rise to new products poses challenges in understanding how they work and impact on the financial system;
- High security and fraud risk (and cost) exist in this country where violence and crime are a real problem (frequent challenges from armed robbery, internal fraud, civil commotion, and other security and corruption related risks are reported). Utilities services are unreliable and robust contingency planning against business disruption is essential; and
- With the private sector credit growth and the development of the LNG project, there are possibilities that new products will be introduced into the foreign exchange market to cater for the needs of customers,
- especially businesses involved directly or indirectly with the LNG project. BPNG would need to step up in regulating this emerging market.

BPNG is prepared to deal with these challenges to ensure that our supervision results in a sound and prudently managed financial system in PNG as experienced to date.

Thank you.