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Welcome!

Although risk governance has always been an extremely important topic, the financial crisis has emphasised the importance of boards of directors and other governing bodies in ensuring the effectiveness of risk management in the entities for which they are responsible. Whether for investment funds, financial institutions or other legal entities, regulators and shareholders have intensified their focus on these governing bodies to ensure that risk is effectively managed.

This issue of the *PRiM Risk Newsletter* focuses on risk governance, not only in investment funds, but also in companies. The *Newsletter* includes two interviews – one with **Simone Delcourt, Director of the Commission de Surveillance du Secteur Financier**, the other with **Justin Egan, Managing Director of Carne Global Fund Services**, and **Bill Lockwood, Conducting Officer of Franklin Templeton Investments**.

The articles in this issue cover a wide variety of topics related to risk governance: The importance of "Balancing the Demands of Group Standards and Local Regulation" is covered

in an article from **avantage** by **Timothy Kent-Phillips, Karine Kias** and **Pierre Ravez, Consultants**; "Risk-Intelligent Governance" by **Laurent Berliner, Partner**, and **Dr. Jean-Philippe Peters, Director, Deloitte S.A.**; Risk Governance vs. Business Development by **Ravi Beegun, Partner, KPMG**; Risk Appetite by **Thierry López, Partner**, and **Benjamin Gauthier, Senior Manager, PricewaterhouseCoopers**.

In addition to those articles directly related to risk governance, we have also included an article by **François Masquelier, Senior Vice President, RTL Group**, on the impact of new regulations on the finance function in companies and an article by **Graham Goodhew, Director and Conducting Officer, JP Morgan Asset Management**, and **Thomas Nummer, Managing Director, Carne Group**, on ALFI's guidelines for managing risks related to outsourcing.

Any ideas for future issues or any comments that you have are always welcome. Please send them to info@prim.lu.

Bonne lecture!
Paul Kleinbart

Note from the Editor:

The individual opinions expressed in this *Newsletter* do not necessarily reflect the opinion of PRiM nor of any other contributors to this edition

KEYNOTE INTERVIEW: RISK GOVERNANCE FROM THE REGULATOR'S PERSPECTIVE

Simone Delcourt, Director, Commission de Surveillance du Secteur Financier



Simone Delcourt

PRiM: What are the main principles of risk governance from the regulator's perspective?

Simone Delcourt: An effective risk governance structure calls, first of all, for a strong risk management involvement of both the Board of Directors and the Senior Management, the former being in particular responsible for:

- the overall risk policy and strategy (including a.o. risk tolerances and risk appetite, etc.), thereby ensuring consistency with the nature, size and complexity of its business;
- a clear allocation of responsibilities within the organisation in terms of risk management.

Secondly, Senior Management, under the oversight of the Board of Directors, shall set up and maintain an independent risk management function with sufficient authority and stature that is in charge of identifying, measuring, monitoring, controlling and reporting all risks a firm is or may be exposed to pursuant to its activities.

Finally, the Board of Directors and Senior Management shall on an on-going basis exercise due oversight over the risk management process for ensuring its adequacy and effectiveness as well as its compliance with the retained risk policy and strategy. An effective internal control system shall support them in that job.

PRiM: How have the latest regulatory developments (e.g. Basle III, UCITS IV) impacted risk governance arrangements in the companies that the CSSF supervises? What benefits does the CSSF hope to get as a result of tighter risk governance?

Simone Delcourt: The latest regulatory developments concerning for instance

credit institutions or UCITS investment funds aim, among other, at strengthening risk governance, focusing on better oversight and involvement of both the Board of Directors and Senior Management as well as improved risk management through a better and more comprehensive risk coverage.

In this respect, tighter risk governance should certainly contribute positively to companies achieving their objectives and so paving the way for their long-term success and continued existence. In conjunction with the other regulatory initiatives (e.g. better capital and liquidity framework for credit institutions, AIFMD), these developments should help to strengthen the resilience of the financial actors and of the financial system as a whole and so to achieve better protection of investors, depositors and other relevant stakeholders.

PRiM: What are the key challenges you see in terms of implementing risk governance arrangements in Luxembourg firms under your supervision that operate globally?

Simone Delcourt: A main challenge for firms operating globally is certainly the tailoring of a risk governance model that, while being in compliance with the local legal and regulatory framework, fits well with the strategy and operational model chosen by the group to which it belongs. Such a model shall of course provide for effective oversight and involvement of the Board of Directors and Senior Management at the level of the Luxembourg firm, but it should allow them to take full benefit of expertise and resources present in other parts of the group. In this sense, the delegation possibilities granted by regulations should represent a key element. Due consideration should in that respect also be given to the so-called principle of proportionality for ensuring that the risk governance model is

appropriate with regard to the nature, size and complexity of the activities.

PRiM: How do you see risk governance to develop in the future?

Simone Delcourt: Important steps towards better risk governance have already been done over the last years.

However, a number of regulatory initiatives (for instance AIFMD, etc.) are still underway, respectively come into force in the next years that should lead to overall better regulated actors and markets.

PRiM: Thank you for sharing your views with us

" A main challenge for firms operating globally is certainly the tailoring of a risk governance model that, while being in compliance with the local legal and regulatory framework, fits well with the strategy and operational model chosen by the group to which it belongs. "

RISK GOVERNANCE: BALANCING THE DEMANDS OF GROUP STANDARDS AND LOCAL REGULATION

Timothy Kent-Phillips, Karine Kias and Pierre Ravez, consultants, avantage



Timothy Kent-Phillips



Karine Kias



Pierre Ravez

Recent banking crises have exposed material deficiencies in the risk governance of some firms. Poor risk governance has been cited a significant contributory factor of those crises. In response, regulatory authorities have increased their focus on the effectiveness of risk governance within the entities that they regulate. This article considers the nature of regulatory development in respect of risk governance and the challenge inherent in addressing the requisite demands of both firm-wide and local standards.

Effective risk governance is central to the secure delivery of a firm's corporate strategy, the protection of its customers and stakeholders, and prevention of wider systemic risk. It should enable a firm's board of directors and executive to interact effectively, to share a clear appreciation of their firm's risk appetite, and to establish and maintain an appropriate control framework to manage risks effectively. Effectiveness is demonstrated by evidence of practical operation, yet today's public perception of financial services is of an industry largely characterised by preoccupation with reward at the expense of risk, corporate arrogance and impenetrable complexity. Such characteristics have indeed been causal to many recently publicised losses and failures. Regulators have acknowledged that effective risk governance is as much about embedding the appropriate culture and behaviours as it is about monitoring systems and controls. Strength of oversight comes through board commitment to understanding complexity and through the pursuit of robust challenge, which in turn requires experience.

Toward strengthening risk governance within UK firms, the FSA has announced its intention to adopt a more "direct and intrusive approach" to supervision. It is becoming more judgmental at the corporate level in relation to the sustainability of a firm's

business model and at the individual level in relation to suitability of persons to hold key functions. The intensity of ARROW (Advanced Risk-Responsive Operating Framework) visits, the tool by which the FSA assesses risk in regulated firms, has increased. Their challenge has become more robust as a consequence of improvement in FSA preparation and skill, while the publication of Consultation Paper CP10/3 'Effective Corporate Governance' expands the scope of controlled functions and strengthens the regulatory process for approval of applications for Significant Influence Functions (SIFs) and subsequent supervision of incumbents. CP10/3 also enshrines key recommendations of the Walker Review, in particular that some firms, notably listed banks and insurers, establish board risk committees and appoint chief risk officers.

Such vetting of individuals for key functions corresponds to the CSSF's approval of authorised management in Luxembourg, yet Luxembourg regulation goes further in implementing risk governance at a local level. Ostensibly focused on strengthening practices in relation to liquidity risk management, Circular 09/403 requires the implementation and maintenance of a local risk management function. The objective is not only to create a key contact for the CSSF but also to assign responsibility at a local level, close to the operation of the local entity. Since 2009, there has been notable buoyancy in the recruitment of independent officers who take on the responsibility for risk management from understanding the entity's exposures to ensuring that resourcing and governance are adequate locally.

Circular 09/403 evidences CSSF concern to see risk governance decentralised beyond the board level in respect of the operations of credit institutions in Luxembourg. Yet many authorised managers work in companies belonging to a foreign group. A consequence

of the circular has been the intensification of tensions between local operations and their head offices in relation to the determination of the risk management approach to be used. Those who accepted local risk management positions have found their diplomatic skills to be as important as their ability to assess risk. Their first endeavour has regularly been to address group resistance or questioning: resistance to their involvement in initiatives focused on provision of a local view of risk, and questioning of the requirement for Luxembourg entities to develop a self-sufficient liquidity management framework that provides local resilience against group difficulty or even collapse. Given the subsidiary or branch nature of Luxembourg credit institutions, the risk manager's principal concern can be viewed as walking the fine line between regulatory and corporate loyalty: the requirement to strengthen local governance, while relying on the practice, resources and systems of a foreign group.

In relation to liquidity management, many local group companies have minimal treasury or financial market capability since they primarily exist to execute client transactions. In such cases, particularly for European groups, the notion of free movement of capital might reasonably be argued and that reliance on group approaches and centralised practices ought to be sufficient to comply with local Luxembourg requirements. In such circumstances the cost of implementing a full-scale local risk management framework becomes difficult to justify when models, tests, and assumptions have been designed and proven efficient from a group perspective. The risk manager is caught between hammer and anvil.

Such issues were again highlighted by the more recent publication of Circular 11/506, through which the CSSF has implemented a requirement that regulated credit institutions undertake stress testing to

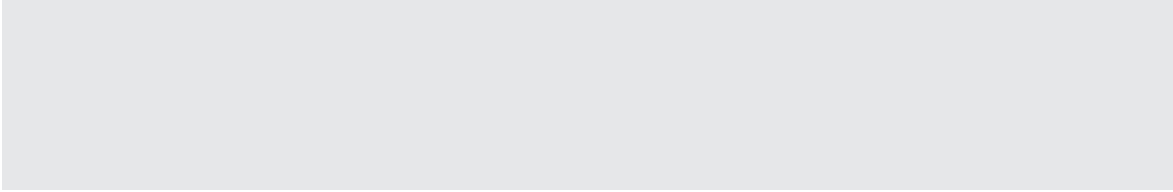
demonstrate the resilience of industry participants to all material risks. Authorised management is required to ensure the conduct of stress testing by their local risk management function with responsibility for implementing, maintaining and publishing the stress test results. Reliance on group approaches is permitted provided compliance with the provisions of the circular can be demonstrated. This includes ensuring that group tools are adequate for the local business, that retention of complete responsibility for local inputs and outputs (i.e., the adequacy of the assumptions, the results and their interpretations) can be demonstrated, and that specific reporting is available for analysis of test results and assessment of risks relevant to the local entity. The regulator expects to see that all steps are taken to manage and monitor risks at a local level and proof will be required. In effect, local Luxembourg management has to demonstrate that they have actively taken part in the shaping of the model, the brainstorming of the assumptions and the running of the tests, so as to interpret and implement the lessons learnt.

Luxembourg regulated entities of larger groups seemingly have two choices: either to develop local stress tests and communicate the results to the group or to rely on the group for its tools and support to achieve compliance with local rules. Where the activities of a Luxembourg entity are wholly different to the ones elsewhere in its group, the local office has no choice but to develop, implement and monitor an appropriate risk framework. This will also be true for Luxembourg business activities that may, for the most part, appear similar to those conducted elsewhere in the group, yet which in practice are operationally different, e.g., private banking in Luxembourg, the conduct of which differs from the one in other countries.

Irrespective of approach, the principle to

be preserved is that stress testing should not be performed as an isolated exercise with little interaction with business areas: sufficient risk ownership and responsibility should be maintained in an integrated manner. Stress testing should not be considered an end in itself: effective risk governance relies on the ability to challenge and manage risk proactively while keeping an eye on the monitoring, measuring and reporting functions. Here it should also be noted that authorised management will always be held responsible for adjusting capital requirements / liquidity buffers should scenarios demonstrate that there is insufficient capital / liquidity.

Various hurdles must be overcome in implementing a local risk management framework, especially in the group context. These include the silo mentality, not only across the business itself, but also when addressing the different types of risks. Risk management might not have the appropriate tools, e.g., due to lack of integration between systems, let alone be willing to share the data in a transparent manner. This introduces the notion of system dependence, a phenomenon that potentially challenges the objective of the legislation. Group tools are often black boxes developed centrally outside Luxembourg, and the local regulated entity is required simply to send data to the group's servers, receive output with very restricted parameterisation possibilities, and have no ability to access the specifications of the tool or model. How could local authorised management in such cases have the freedom to tailor a stress test or input to the parameters, scenario and configuration to reflect a closer resemblance to local reality? A further system-related issue is the source of information and the transfer of data: different systems may be used in Luxembourg due to the specific business requirement to avoid inter-group connection in the interests of

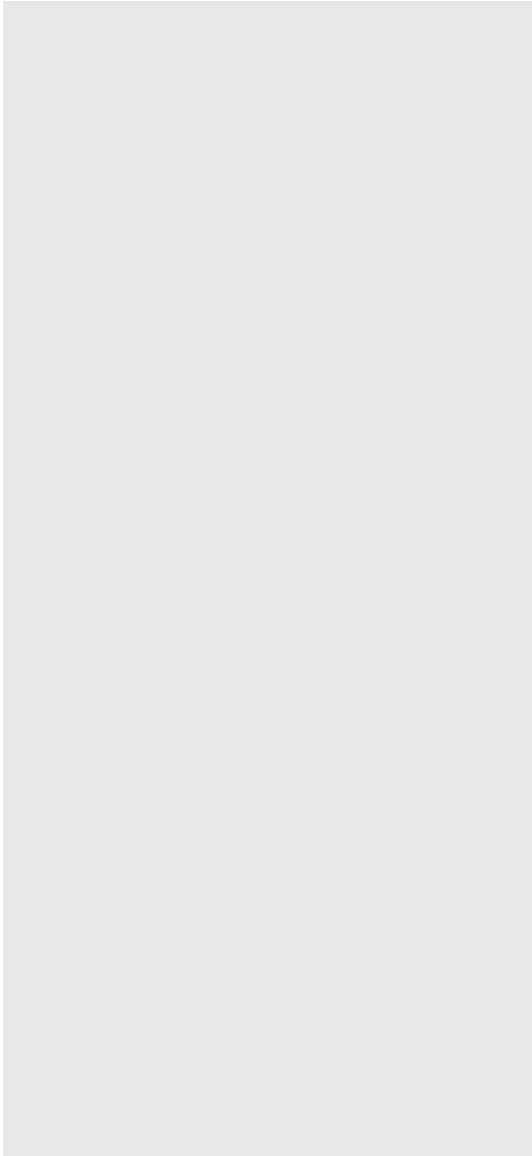


private banking confidentiality rules even though they are part of the same group. Local entities may therefore be using the same group system but implemented in a very different way. Implementation of an appropriate local risk infrastructure often encounters difficulties at the “people” level: the successful risk team will have to recruit and retain the right talent comprising the appropriate mix of know-how and skill sets – not such an easy task in the Luxembourg market – as well as access at all levels to the key information and methodologies for successfully implementing a risk framework.

In the meantime the context is not static: markets and products become increasingly complex and decreasingly liquid. Service and product offering evolution, along with growth through acquisition, create challenges for the risk manager to assess the risks and communicate the appropriate picture to the risk committee and board. Transparency of risk information is the key to integration of such change and its effect on the management of the risk exposures: ready access to local and group data based on common principles and formats permits the risk manager to model and assess exposure locally and on a group basis. Leveraging or implementing databases and systems that are sufficiently flexible to accommodate local compliance and integration with group systems is paramount, and reliance on group practice and know how may be appropriate where adaptation would meet local requirement. New system implementations, however, are a major investment and might not be a panacea.

It is expected that board intentions for risk governance and management should be captured and documented. However, if the risk appetite definition and the link to risk tolerance have not been clarified at group and local level and appropriately cascaded down to the operational level, managing

the risk within the company to CSSF tolerance becomes nearly impossible. The local risk management framework should not be seen as an additional barrier to the conduct of business, but as embedding an enhanced level of management control that supports decision-making. As a result, day-to-day procedures and controls should provide sufficient background and support to manage risk proactively and provide risk-reporting information that will flow through to the risk committee, while satisfying the local regulator.



KEYNOTE INTERVIEW: GOVERNANCE FROM THE BOARD PERSPECTIVE

An interview with Justin Egan and Bill Lockwood



Justin Egan



Bill Lockwood

In addition to the interview with Simone Delcourt, which views risk governance from the perspective of the regulator, **PRiM** interviewed a fund director, **Justin Egan**, the **Managing Director of Carne Global Fund Services, Luxembourg** and **Bill Lockwood**, **Conducting Officer of Franklin Templeton Investments, Luxembourg**, to understand the concerns and ideas of fund boards.

PRiM: How would you define risk governance from your own perspective?

Justin Egan: At the Carne Group, we believe that effective governance through a strong board of directors and senior management / conducting officer is essential for reducing and managing risk in investment funds. Adequate risk culture and awareness need to be set by the responsible body top down. Otherwise risk management as requested by regulation may be seen too much as just an exercise to comply with given regulations.

The role of fund governance is to identify all relevant risk categories that a fund faces and ensure that the relevant board of directors is aware of those risks and their potential danger. Only after those risks have been identified can they be monitored and managed effectively. In this context, we find that independent directors are especially important, because they view a fund from the outside and have a better/more objective overview of the wider context in which the fund operates. They also represent the perspective of the investor as they are not conflicted.

A recent court case in the Cayman Islands, *Weaving Macro Fixed Income Fund Limited vs. Stefan Peterson and Hans Ekstrom*, is likely to have a significant impact with regard to the importance of fund governance. The case clearly described the minimum expectations from fund governance and the board of

directors that investors should have. The case also highlighted the risks that poor corporate governance represents. Although the Weaving case was in the Cayman Islands, it will probably become an international precedent.

The increased focus on fund governance that we have seen in the last five years is indicative of a strong trend in the market to ensure the stability of funds and to protect the interests of their investors through governance.

Bill Lockwood: Before coming to the question of governance, I would like to put risk into perspective. Risk is a common enough term, but few people seem to share a common understanding of it. Many investors view risk in its most absolute and adverse terms - the possibility they will lose money. Others take a more relative tack towards the negative - the chance an investment will perform poorly compared to a peer or a benchmark. For active investment managers like Franklin Templeton, though, risk is to some extent a precondition of all outcomes: participation in nearly every area of the financial markets entails some risk exposure.

Risk becomes a problem when it is unintended, misunderstood or uncompensated - all of which come to light in any gap between investor expectations and actual performance. The basic job of risk management, then,

is not to eliminate all risk. It is to close the expectations gap by trying to ensure that risk is intended, understood and compensated.

With regard specifically to governance, I can perhaps best describe risk governance by analogy with our own situation in Luxembourg today. Our flagship fund in Luxembourg is a UCITS, Part I fund. In accordance with the UCITS regulations, the fund has entrusted the financial risk management and control processes to risk management units of Franklin Templeton, which are independent of the units in charge of making portfolio management decisions.

The board of directors has the ultimate responsibility for ensuring that there is adequate oversight and follow-up of the fund's investment risks, that the fund's investment risk procedures and controls comply with applicable rules and regulations and that they are operating effectively.

The conducting officers or *dirigeants* as agents of the board of directors are also responsible for monitoring the risk management reporting, following-up on any exceptions and assisting the board of directors in ensuring that the fund investment risk procedures and controls comply with applicable rules and regulations.

The fund harnesses the support of various specialised risk management and control groups of Franklin Templeton to monitor the risks of each sub-fund. Risk management groups are spread across the globe with

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- Bill Lockwood

the mandate to integrate investment risk management into the fund management process. Risk processes are adapted to each sub-fund depending on its underlying investment requirements and complexity.

The fund also adheres to the *ALFI Code of Conduct for Luxembourg Investment Funds*, which has as one of its principles that the board should ensure that an effective risk management process and appropriate internal controls are in place. An important recommendation in the Code – and a reflection of the financial crisis when the code was drafted in September 2009 – is that: “The Board should ensure that an appropriate risk management system is in place which appropriately covers all types of risks including but not limited to investment risk. The Board should ensure that they understand the impact of any complex financial products on the risk profile of the portfolio and the aggregate exposure of the fund to these products.”

PRiM: Since the start of the financial crisis there have been numerous regulatory changes (e.g., UCITS IV, AIFMD, Basel III). How have they impacted risk governance?

Justin Egan: It is well known that since the start of the financial crisis regulators have been very busy developing and issuing new regulations for the fund industry. Every new regulation concerning funds entails more work for fund directors, who are ultimately responsible for ensuring that a fund complies

with the applicable regulations. Particularly demanding in this regard are the recent changes that we have seen at the European level with the UCITS IV package (levels I, II and III) and which is reflected in particular in CSSF circular 11/512 and regulation 10/04. While these regulatory documents build on previous ones (i.e., UCITS III, CESR’s paper on risk principles and the CSSF circular 07/308), they have extended risk management in funds far beyond the previous requirements.

Today, UCITS funds and their directors need to understand and manage all types of risk, including operational risk and liquidity risk.

In response to this challenge, the composition of fund boards is changing. Traditionally, the members of fund boards often comprised representatives of the fund manager, employees of the fund’s service providers and the fund’s lawyer. Fund boards today are increasingly focused on having directors with extensive technical expertise who are able to judge the risks that a fund faces. We believe that independent directors are

well suited for this role, because they usually have a considerable amount of experience and technical knowledge of the fund industry. The trend towards more technical fund boards is growing, but it will take time until the market changes completely.

Bill Lockwood: During the depths of the 2008/2009 financial crisis, professional and individual investors witnessed markets plummeting across the board and certain asset classes collapsing altogether. More regulation was therefore to be expected.

" Today, UCITS funds and their directors need to understand and manage all types of risk, including operational risk and liquidity risk. [...] The trend towards more technical fund boards is growing, but it will take time until the market changes completely. "

- Justin Egan

Perhaps confining myself to UCITS IV since this is the regulation which most impacts our current activities in Luxembourg. On May 30, 2011 the CSSF published a UCITS Risk Management Circular (CSSF 11/512) that came into effect as from July 1. The new circular applies to UCITS management companies and self-managed SICAVs and replaces the current Circular 07/308.

The objectives of the new CSSF circular are threefold:

1. It describes the main changes to UCITS risk management introduced by the new Luxembourg fund law of December 17, 2010 (transposing the UCITS IV Directive), the CSSF Regulation 10-4 and the related ESMA (European Securities and Markets Authority) detailed guidelines.
2. It sets out additional CSSF guidance on some specific rules and requirements.
3. It defines the content and format of the risk management process (RMP) documentation that needs to be updated and submitted to the CSSF by December 31, 2011 at the latest.

The circular highlights the rules governing key areas of UCITS risk management, e.g., the risk management policy needs to be adequately documented and procedures put in place to enable the management company/self-managed SICAV to assess the exposure of the fund to market, liquidity and counterparty risks, and the exposure of the fund to all other risks, including operational risks, which may be material.

As conducting officers, we have described

the changes to our board of directors and we are working with the risk management teams to implement fully the requirements of the new circular before the end of the year. Liquidity risk management and the stress testing thereof are perhaps the more challenging new requirements.

It is important to note that Franklin Templeton seeks to manage risks consistently with the investment objectives outlined in our prospectus and communicated to our investors, regardless of changes in the applicable regulations. We clearly have to comply with the regulations – that is an absolute – but the regulations really provide more of a “guard rail” and are no substitute for effective risk management.

" We clearly have to comply with the regulations – that is an absolute – but the regulations really provide more of a “guard rail” and are no substitute for effective risk management. "

- Bill Lockwood

PRiM: How important is risk governance in the push to create a more secure financial climate? What are the obstacles to achieving this goal?

Justin Egan: As I mentioned in my answers to the previous

questions, strong governance is essential for the strength and survival of a fund. We recently conducted and published a survey on corporate governance in hedge funds. The results of the survey show that professional investors rate strong governance very highly as a criterion that makes a fund attractive. 90% of the investors whom we interviewed agreed that poor governance would cause them to avoid investing in a fund, even if it performed well. 80% of the investors rated fund governance as “extremely important”. But professional investors know that in the present environment they cannot rely entirely on fund directors, so they perform their own research and due diligence on a

fund. They obviously would prefer to have reliable directors and strong governance, so that they would not have to perform due diligence on their own.

Bad governance is a high risk factor, which brings no return to the investor. Fund managers, therefore, must recognise the importance of strong governance as a means of protecting the interests of investors and the long-term stability of their funds. Good governance starts with a strong, well-informed board of directors and should include some independent directors who are not conflicted and will represent the investors' interests.

Bill Lockwood: I believe good risk governance is vitally important to creating a more secure financial climate. I suspect that the challenge will lie in whether we have a "principles" rather than a "rules" based approach to risk governance. There are many who would argue that a more prescriptive approach is appropriate given that the lessons of the financial crisis may not have been learned. I believe that investment risk professionals exercising good judgement rather than following prescribed codes is a *sine qua non* for good risk governance. This recognises that the right approach for many risk issues will depend upon the circumstances. If we have learned one thing from the crisis, it is that tunnel vision, e.g., investment managers relying solely upon a purely model-driven or quantitative approach, is a recipe for disaster. Another inherent feature of the financial markets is that they will virtually always move faster than the regulations can adapt.

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- Justin Egan

This is why at Franklin Templeton we believe a risk management plan developed from within an organisation and integrated within the investment management group is the most effective approach. Investors should examine and compare their investment managers based on this criteria – *how effectively do they manage risk?*

PRiM: To what extent is transparency important in any risk governance framework?

Justin Egan: Transparency is a crucial aspect of fund governance, particularly for institutional investors. Performance is and will be a key criteria for investors; but how such performance is achieved and what level of risks has been taken are also of utmost importance for investors today.

Before investing their money in a fund, investors would like to know who is responsible for the safe operation of the fund and exactly how the fund is governed. They therefore expect complete transparency in terms of fund governance and the performance of the fund's board of directors. The fund boards, on the other side, must be open, honest and accurate in their communication with investors.

Many institutional investors insist on interviewing independent directors to understand what value they add to the boards on which they serve. Since independent directors are paid for their services, they must prove that they add value.

The trend towards transparency has become

increasingly important in recent years and is likely to continue in the future.

Bill Lockwood: The other side of the coin to my introductory remark that risk becomes a problem when it is unintended, misunderstood or uncompensated is that risk needs to be recognised, rational and rewarded.

Franklin Templeton uses a comprehensive, integrated risk management approach designed to determine whether investment risks are:

- **Recognised** – risks should be recognised and understood at the security, portfolio and operational levels.
- **Rational** – risk decisions should be an intended and a rational part of each portfolio's strategy.
- **Rewarded** – every risk should have commensurate long-term reward potential.

Transparency in a variety of forms is absolutely necessary to execute this approach to risk management. The internal risk and compliance teams need access to both information and the decision makers in order to be effective.

PRiM: How do you see risk governance developing in the future?

Justin Egan: Recent changes in regulations, such as UCITS IV, the CSSF circular 11/512, indicate that fund governance and the responsibilities of fund directors will

become increasingly demanding in the future. The recent AIFMD level II consultation shows clearly that ESMA will ask for similar requirements on the roles and responsibilities of the board for all non-UCITS products in 2013.

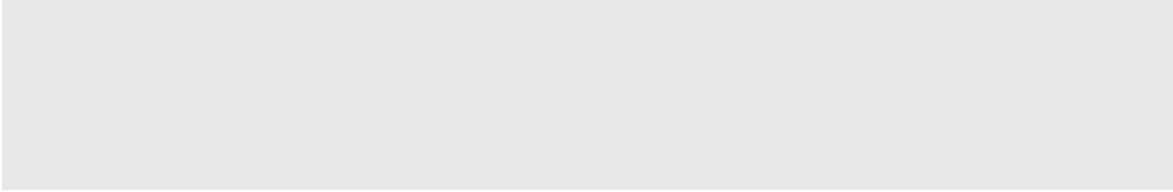
" I believe that investment risk professionals exercising good judgement rather than following prescribed codes is a *sine qua non* for good risk governance. This recognises that the right approach for many risk issues will depend upon the circumstances. If we have learned one thing from the crisis, it is that tunnel vision [...] is a recipe for disaster."

- **Bill Lockwood**

In this trend, international fund markets in Europe, such as Luxembourg and Ireland, will play a leading role. In Luxembourg, there is increased pressure on fund directors not to overload themselves, so they can perform their jobs thoroughly and responsibly. The Irish fund market will soon publish a document that describes the requirements for effective fund governance. The EU has published a green paper on corporate governance in financial institutions.

The main impetus for the improvements in fund governance is coming from investors and regulators. For investors, good governance is essential for protecting their own investments. For the regulators, it is a precondition for creating strength and stability in fund markets. While fund markets were booming,

no one worried too much about governance. The financial crisis and the downturn that fund markets experienced in 2008 caused fund managers, investors and regulators to focus more on fund governance. While considerable progress in this area has been achieved, there is still a lot of room for improvement.



Bill Lockwood: Between the ever-evolving nature of the financial industry and the possibility that the recent regulatory overhaul will alter the industry's landscape, it is almost impossible to predict where risk management is headed.

At Franklin Templeton, with our multi-faceted view of risk, we are moving through this challenging period by embracing continual development. By adding new layers of risk analysis roughly four years ago including the creation of a Counterparty Credit Committee and a Complex Securities Review Committee in 2007, Franklin Templeton was able to act effectively on early signs of financial-sector troubles.

No control environment is capable of fully mitigating risks 100% of the time. The approach Franklin Templeton has taken is to identify potential events that may negatively affect investors and to establish an internal control environment that seeks a reasonable level of protection, while still allowing our investors to participate in financial markets. Alignment with Franklin Templeton's values and philosophy, management awareness and actions and robust policies and procedures will be our best support in navigating the risks that lie ahead.

PRiM: Thank you for sharing your views with us.



RISK-INTELLIGENT GOVERNANCE: THE APEX OF RISK MANAGEMENT

Laurent Berliner, Partner, Business Risk Leader, Deloitte S.A., PRiM Board Member and IIA Luxembourg Board Member;
Dr. Jean-Philippe Peters, Director, Enterprise Risk Services, Deloitte S.A.



Laurent Berliner



Jean-Philippe Peters

Risk governance is certainly one of the most compelling and top-of-the-mind issues in our time, not only because it is one of most prominent features of the regulatory landscape in many industries, but simply because the crisis has shown that conventional risk governance and oversight approaches have failed.

The unstable economic environment emphasises with an unprecedented intensity that executives and board members should properly identify, thoroughly understand, manage and oversee the key risks facing their organisations.

In the *Deloitte Lexicon*, risk intelligence is the epitome of effective risk management, an aspirational state defined by this insight: organisations that are most effective and efficient in managing the full spectrum of risks to both existing assets and to future growth (i.e., developing capabilities to make superior risk-informed decisions) will, in the long run, outperform those that are less so.

A risk-intelligent organisation draws on the coordinated efforts of three layers of risk management responsibility, which are depicted in [Figure 1: Governance, Infrastructure and Ownership](#).

A risk intelligent governance is the one that incorporates risk intelligence into the ways the organisation's business is understood and managed so as to be in the position to decide more effectively under uncertain conditions and increase the chances of resilience and sustainable success of the organisation.

Simply put, organisations generate revenue and make profit by taking risks and make losses by failing to manage them properly. Some level of failure is inherent to any activity and even necessary for innovation and growth. The stake is to avoid the unrewarded risks (e.g. non-compliance with regulations, critical operational failures, lack

of integrity in financial reports, tarnished reputation, etc.) that offer no premium for being taken when compared to the damage they inflict when crystallising, and to take enough of the right risks (e.g. new initiatives such as entering new promising markets, developing new products, new business models, new distribution channels, making acquisitions, etc.), the ones that bring reward if done in a reasoned, calculated, manageable and monitored way.

Briefly said, risk is the potential for failure and Enterprise Risk Management is actually about sound and effective Enterprise Management: it is about accepting a reasonable level of risk to seize opportunities and create advantage or suppress a disadvantage in the competitive business environment. Governance and risk governance live on top of those management activities, and primarily

encompass the board-level ultimate responsibilities to ensure the organisation's resilience and success. To succeed in the long run, organisations need to make the right risk-informed business decisions and to wisely determine, manage and oversee acceptable vs. unacceptable levels between actual and expected performance.

In other words, risk governance is the apex of any cohesive enterprise risk management framework, the guide to the organisation's risk management as a whole. But what does effective risk governance really entail?

Based on our experience working with boards in their risk governance efforts, we explore in this article those focus areas that directors should particularly consider to embrace in what we call a "risk-intelligent" approach, and most effectively fulfil and discharge their heightened board-level, risk-related oversight roles and responsibilities.

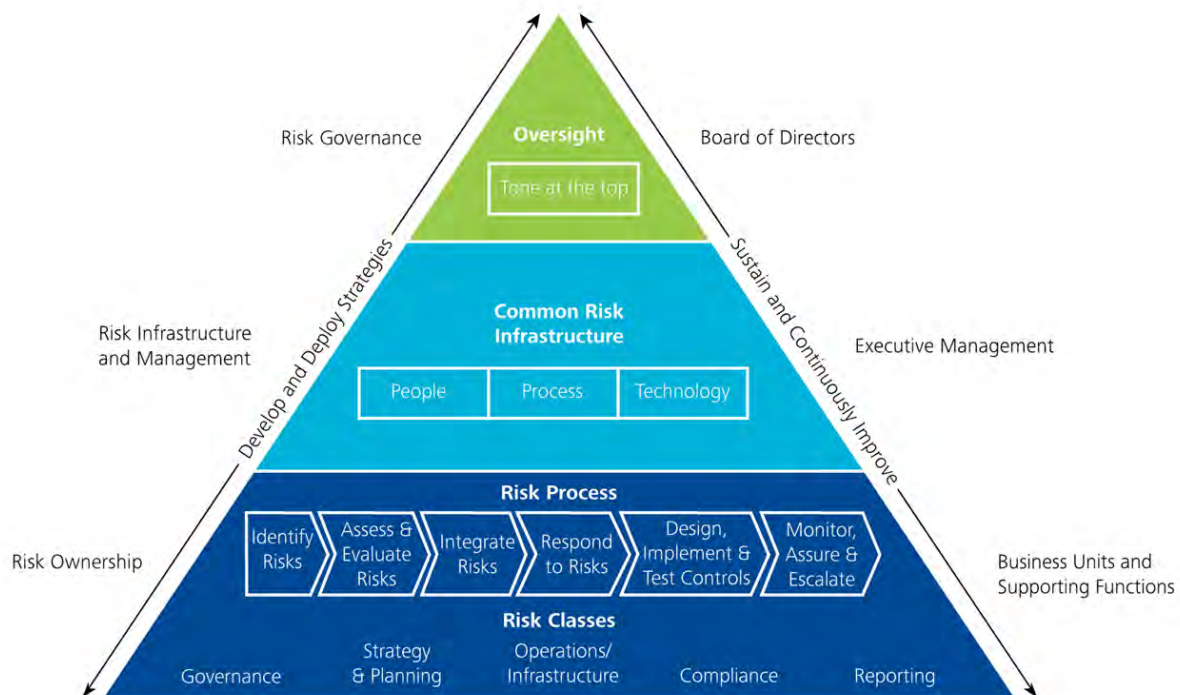


Figure 1. The Risk Intelligent Enterprise™ framework - Deloitte Development LLC. All rights reserved.

Risk-intelligent governance approach; linking risk and strategy.

"There is no security on this Earth. Only opportunity" - Douglas McArthur

There is actually no magic recipe, no set of golden rules to follow, no way to keep the organisation fully shielded from the world's uncertainty and turmoil. Risk-intelligent governance is more a path to enhancing value and managing risks that enables better decisions and therefore increases the chances of resilience and competitive success.

Risk considerations must be embedded into the strategic and tactical decision-making processes of the enterprise and should not be viewed as a side activity. Under hectic conditions, the challenges to judgment can be huge. Critical decisions must be made within a very limited period a time, with partial or even contradictory information and advice about the best way to navigate.

Risk management (i.e., the executives' role) and risk governance (i.e., the directors' role) must therefore start with a thorough understanding of the strategic goals and objectives of the enterprise and of its articulation with the shareholders, clients, employees, suppliers and all other stakeholders. Directors and executives should develop and select on this basis strategies and initiatives by which the organisation will deploy resources to create and protect value in ways that are consistent with its mission.

The fact is that risk, or more specifically intelligent risk-taking is the basis for business success. Try to avoid all risks, do not take enough of the good risks and you will miss success too. Neglect risks that may kill value and you may destroy the organisation as a whole.

Inherent to the director role is to set the

tone for making management - and in turn everyone in the organisation - responsible for risk, for getting people thinking about intelligent risk taking for reward, for pushing risk management through all the various levels of the organisation, to set expectations, provoke the necessary changes, ensure accountability and establish a risk intelligent culture.

Put risk-intelligent governance in practice

Good governance enables sound decision-making and risk-intelligent boards probe and challenge management to gain insight and exercise oversight. They understand the mechanisms of value creation or destruction in the business, how capable and prepared is the organisation. In other words they understand and keep a close eye on the key drivers of success.

What are the ways for the board to ensure that consideration of risk is built into the ways decisions are made and to oversee that risks are being appropriately managed?

Tip #1: Insight into the risks and the risk management infrastructure

To foster risk-intelligent governance, governing bodies (i.e., boards and their committees) should first of all have appropriate insight and interaction with the organisation's risk management practices, and risk should be a regular point of discussion at board meeting.

The board is ultimately responsible for risk oversight of the organisation. Inherent in risk oversight is having a good understanding of the risk processes and policies that have been established, upon which to manage risk. The process of enterprise-wide risk identification and assessment is a significant part of any risk management framework, in which management takes a lead.

As part of the enterprise-wide risks identified, boards should be informed about what the key enterprise risks are and about the organisation's risk management infrastructure, i.e., the way risks are managed so as to be able to exercise effective oversight.

Tip #2: Discuss and constructively challenge strategies and the risk associated with their successful implementation

"It ain't what you don't know that gets you into trouble, it's what you know for sure that just ain't so." - Mark Twain

Boards should engage management in periodic risk discussions to identify proactively and challenge the risks to the strategy (i.e., the factors that could jeopardize the successful execution of a strategy) but also the risks of the strategy itself (i.e., the risk that the chosen strategy is not – or not anymore – the correct strategy).

Many conventional approaches to risk management and risk governance make the incorrect assumption that the strategy is and will remain the right one and that, as far as the risks that would make the strategy execution fail are identified, managed and overseen by the board, it will work.

Tip #3: Discuss risk scenarios, risk interconnectedness and anticipate causes of failure

"All truth passes through three stages. First, it is ridiculed. Second, it is violently opposed. Third, it is accepted as being self-evident" - Arthur Schopenhauer

Experience leads people to make assumptions about the probability of an event occurring and wrong assumptions that can trigger lethal consequences for an unprepared organisation. Moreover, even a strategy that proved to be successful can become ineffective due to changes either in the external environment or within the

organisation. What was once the reason for success can overnight become the reason for a disaster. Boards should therefore also challenge as to whether the organisation has developed sensor capabilities to capture possible shifts that would jeopardise key assumptions underlying the strategy and grasp the potential implications for the strategy to respond in a timely way and revise the strategy where necessary.

Typically, those strategic risk discussions between directors and executives should be framed around scenario planning that helps identify direction, impact and speed of onset of the effects of changes affecting the key drivers of the organisation (e.g. revenues, costs, profits), but also around efforts to understand the key dependencies of the organisation (e.g. suppliers, IT infrastructure, service provider) and the level of preparedness for significant disruption or for opportunities that may be seized in this regard.

Consideration should also be given to the interconnectedness between multiple risks rather than merely focusing on a single event and consider the impacts that would result from multiple risk factors. While the need for specialisation by business function must be acknowledged, it is vital in this regard to drive synchronisation of risk management and controls across the organisation in order to bridge silos that would lead to disconnected risk management and risk governance approaches and considerations.

While such analysis of adverse scenarios becomes a regulatory requirement for financial institutions (as part of the Internal Capital Adequacy Assessment Process, or ICAAP, for banks and investment firms and the Own Risk and Solvency Assessment, or ORSA, for (re)insurance undertakings), the exercise is of great managerial usefulness for all industries.

Tip #4: Shape risk appetite, monitor risk profile and continuously challenge both of them

Boards should monitor and constructively challenge how much risk the organisation is able to take on, how much the organisation is willing to take on, how much the organisation is actually taking on and ensure that all those are in line. In defining the risk appetite of the organisation, boards should ask and answer the following probing questions:

- What is our risk appetite?
- What are the dimensions to which it should be linked (earnings, volatility, solvency, liquidity, etc.)?
- Will it vary based on the type of risk?
- What are the rewarded risks vs. the unrewarded risks (operations, reporting and compliance)?
- Are we taking enough rewarded risk?
- What are we willing to bet?
- What can we bear to lose?
- How capable are we really to manage those risks?
- How much variability from targeted performance are we willing to tolerate (i.e., are there appropriate limits and thresholds in place)?

By addressing these questions, boards actually translate generic desired risk posture into concrete operational limits and metrics. While we know from experience that the exercise is not an easy task and needs several iterations to become fully embedded in the decision making process of the organisation, we also know that the actual initiation of the process provides in itself short-term rewards that are worthwhile grasping.

Tip #5: Get independent risk management (re) assurance

As any other internal process, the risk

management practices of the organisation should be independently reviewed to provide Boards with effective reassurance from their internal audit function about the design suitability and operating effectiveness of the full risk management program. This includes reassurance as to whether the executive risk reports are relevant (i.e., focus on what matters), reliable, timely and complete.

In particular, when the organisation is relying on quantitative models for measuring and monitoring some of its risk exposures (mostly financial risks) and use them as the 'backbone' of the information used to inform decisions about the business, independent review of the proper governance surrounding the models and of the underlying assumptions as well as mathematical foundations is of critical importance to support the risk oversight duties of governing bodies.

Conclusion

A vital condition for managing risks efficiently is to design and implement appropriate governance schemes and adequate risk oversight activities to be carried out by the governing bodies. Risk-intelligent governance is actually about sound and effective governance, simply about providing the appropriate level of direction and oversight to ensure that sound decisions are taken and implemented in the pursuit of sustainable business success.

Every strategic decision or activity involves some degree of risk, a level of potential for failure. Hence effective governance calls for what we call risk-intelligent governance, an approach, primarily exercised at board level that fosters appropriate risk-taking while also embedding appropriate risk management attitude, behaviours, infrastructure and processes at every level and in any activity of the organisation.

Risk governance should therefore be viewed as the apex of any cohesive enterprise risk management framework

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RISK GOVERNANCE VS. BUSINESS DEVELOPMENT: BACK TO BASICS - CAN WE GET THE BALANCE RIGHT?

Ravi Beegun, Partner, KPMG and PRiM Board Member



Ravi Beegun

Risk governance is not a new topic. To a certain extent, its visibility is anti-cyclical. In an economic downturn, risk governance becomes an area of focus for all stakeholders, whether they are investors, board members or regulators. In contrast, during economic booms, it is overshadowed by the growth or business development agenda, until the next crisis/financial accident.

But what is new this time is the magnitude of the current crisis. It has put pressure on politicians and regulators alike, and in turn it has led to new regulations demanding sound risk management processes with proper substance. As sound risk management can only be achieved with sound risk governance, it is important to get this first step right.

What are the recurring weaknesses?

A 2010 report from the Economist Intelligence Unit, sponsored by ACE and KPMG "Fall guys, Risk management in the front line" highlights the following key findings:

- Strategic risk management remains an immature activity in many companies
- Only a minority of companies involve risk functions in key business decisions
- Risk managers want to spend more time on the constructive aspects of the role
- There is limited appetite for investment in the risk function
- Risk functions have increased in authority, but there is a danger that this will not be a permanent change
- There are doubts about the risk expertise among non-executive directors

A number of these findings can equally have been applicable a decade ago. And the fact that they recur means that risk governance is not happening effectively.

Can a balance between performance, innovation and risk management be achieved in practice?

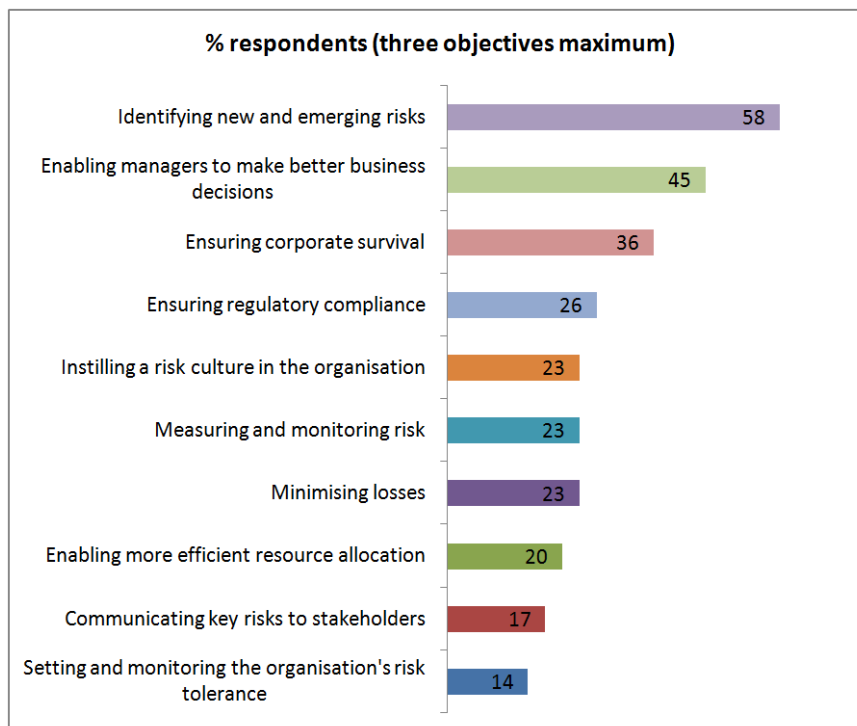
In practice, risk management is often perceived as being responsible for blocking new ideas for business rather than actively helping business enablers to grow the company, while ensuring that excessive risk exposures are kept at bay. Too often, this can lead to a situation in which risk is ignored when growth is the first priority.

In order to break this mould, governance bodies have an important role to play in setting the tone at the top and leading by example. The human factor and efforts involved in getting business enablers/innovators and risk managers to work together jointly to achieve a sustainable growth agenda are not to be underestimated.

At the end of the day, the collective soft skills and experience of the governance bodies, and the time spent on this topic are likely to be the determining factors as to whether proper risk governance takes place. The objective of risk governance should be to facilitate sufficient discussion and analysis around strategy and risk exposures, to safeguard from the discussions becoming too technical and missing the big picture, to obtain independent and expert views where relevant and to help the teams move towards the right solution, which accommodates both the business objectives and avoids significant risk to the company. Once the respective business teams and risk teams start operating within such a mind set that is led from the top, the hardest part of achieving a proper balance will surely be finished.

Top three areas where risk governance needs to improve – survey findings provide an indication

What, in your opinion, are the most important objectives of the risk management function?



Source: *Fall guys – Risk management in the front line*

A report from the Economist Intelligence Unit Sponsored by ACE and KPMG, 2010

ENTERPRISE RISK MANAGEMENT: PRAGMATICALLY COMBINING RISK APPETITE TOGETHER WITH STRATEGY

Thierry López, Partner, Risk Management Services Leader and PRiM Board Member & Benjamin Gauthier, Senior Manager, Risk Management Services, PwC Luxembourg



Thierry López



Benjamin Gauthier

Regulatory pressures and a greater focus on corporate governance have been a stimulus for many changes in the industry – one of these has been the recognition of the need to articulate risk appetite more clearly. Risk appetite is a term that is frequently used among financial services professionals, but its concept and application are not clear for many. Organisations of all kinds and sizes are struggling to understand and implement meaningful processes, metrics and strategies with regard to risk appetite.

Governance and Enterprise Risk Management

One of the governance challenges organisations face is to align their risk management approach to their business strategy.

Governance refers to the operating model and decision-making framework of organisations to pursue and attain objectives that meet the demands of shareholders and stakeholders.

Enterprise risk management refers to a process to identify, assess, and manage risks, using techniques such as risk assessment, scenario analysis, and stress testing as a basis for determining response strategies that align with the organisation's objectives, risk appetite and tolerance.

Combining these two, we can say that **risk governance** starts at setting the business strategy and the related **risk appetite**, which then needs to be cascaded down by setting clear **risk tolerance levels** for each **business objective** making then a clear link between management's accepted risk levels and levels of risks taken in the day-to-day business.

Risk Appetite and Risk Tolerance

The business strategy defines the long-term goals and direction of the business, consistent with the overall mission

and vision. It drives the organisation's **risk appetite**, which is the level of risk that the Board and Senior Management are willing to accept in pursuit of growth.

A well-defined risk appetite statement should reflect investor aspirations and take regulatory requirements into consideration.

Risk tolerance is the acceptable level of variation relative to the achievement of objectives, and often is best measured in the same units as those used to measure the related objective. Risk appetite provides the framework to define detailed risk tolerance levels across the business. The sum of all risk tolerances cannot exceed the risk appetite.

Combining a top-down and a bottom-up perspective ensures that there are no mismatches between the company's actual risk exposure and defined risk appetite.

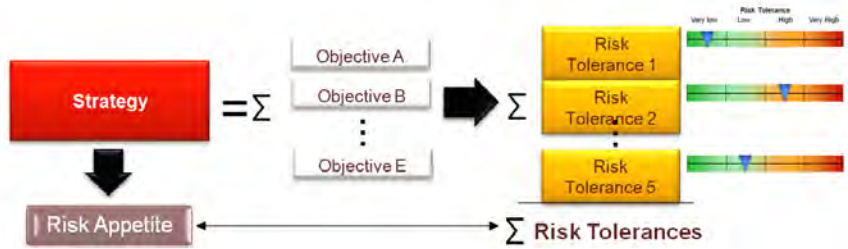


Figure 1

Figure 1 above summarises it.

A Pragmatic Approach to Risk Appetite

Based on the company's strategy, the risk appetite is then defined. It includes both quantitative and qualitative limits.

Even though having a clear and well structured risk appetite will constitute an important tool to ensure that risks taken to reach performance objectives are within the limits defined by the management, it only starts to be relevant once it is challenged by applying a bottom-up approach which

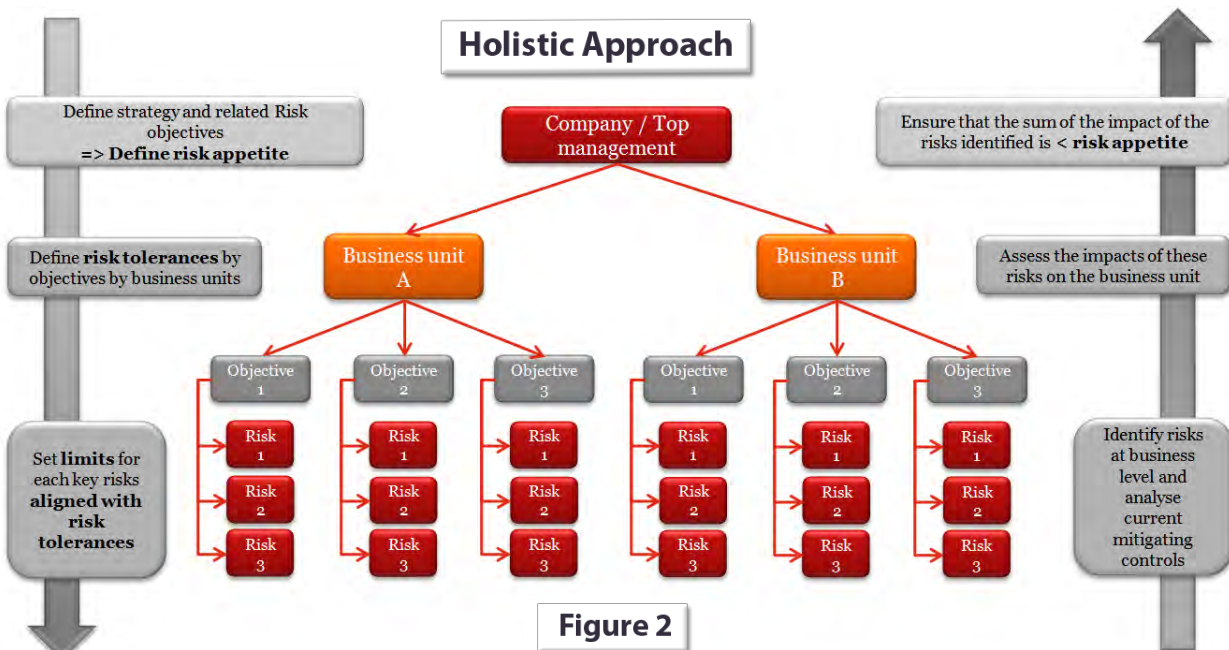


Figure 2

starts from current and actual levels of risks taken and comparing them to the defined risk appetite levels.

For all risk appetite limits that have been set using a quantitative approach, using a properly defined risk aversion matrix constitutes a strong tool to challenge defined limits that have been defined using a Top-down approach.

Regarding this matrix (Figure 3) the management will firstly define likelihood levels since these are not equally weighted. Then, levels of impacts will be defined. In a final stage, green / amber and red areas will be set so that acceptable risk levels and non-acceptable risk levels will be clearly identified.

Based on this agreed structure, a risk aversion matrix will be defined for each quantitative limit.

These matrices will then be populated by weighting the potential impact of identified risks (see ① and ②) by their likelihood of occurrence. Following steps are taken in this process:

1. Selection of business objective, e.g., "objective A",
2. Determination of the level of risk tolerance for objective A,
3. Identification of major risks threatening

4. For each identified risk (① and ②), determination of its likelihood of realisation and estimate of its maximum potential impact,
5. Comparison between the quantified impact sum of identified risks for objective A with the risk tolerance level defined for objective A,

LIKELIHOOD	Very probable 0.85	8 500 €	51 000 €	127 500 € ②	1 275 000 €
	Probable 0.50	5 000 €	30 000 € ①	75 000 €	750 000 €
	Possible 0.20	2 000 €	12 000 €	30 000 €	300 000 €
	Nearly impossible 0.05	500 €	3 000 €	7 500 €	75 000 €
IMPACT					
		Very low	Low	High	Very high
FINANCIAL		[0€ - 20K€] 10 K€	[20 K€ - 100K€] 60 K€	[100K€ - 200K€] 150 K€	[> 200K€] 1 500 K€

Figure 3

6. Undertaking of risk mitigation actions in case risk impact exceeds risk tolerance level.

Operating within risk tolerance levels helps ensure that the organisation remains within its risk appetite and, in turn, gives reasonable assurance it will achieve its business objectives.

HOW WILL THE NEW REGULATIONS AFFECT BUSINESSES AND THE FINANCE FUNCTION?

François Masquelier, Senior Vice President, Head of Treasury & Corporate Finance, RTL Group



François Masquelier

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This article describes the possible impact, both financial and organisational, of the ever more numerous and ever more restrictive new international regulations. What should corporate treasurers and CFOs fear over the next few years? The impact threatens to hit companies at a time when the economic landscape keeps changing at an ever-faster pace. It is against this extremely unsettled backdrop that we have to anticipate the impact of the new post-2008 financial crisis standards.

A constantly shifting risk landscape

One of the major challenges for CFOs, and to a certain extent also for treasury officers, is being able to adapt in an ever more hostile and volatile economic and regulatory environment. A 2010 Ernst & Young survey (E&Y Business Risk Report 2010) emphasised that the number one risk for the approximately 500 CEOs surveyed was the "regulation and compliance" risk. On the face of it, this finding would seem to appal treasurers and even their CFOs. This same risk was ranked in second place in the previous year. It is a very clear illustration of the fear that the juxtaposition of these new regulations seems to arouse in the minds of the managers of multinational corporations (MNCs). It is also worthwhile noting that risk number two is access to credit. This latter risk is (in)directly bound up with the future Basel III and with the still visible stigmata of the great 2008 liquidity crisis. Furthermore, the Radical Greening and the corporate social responsibility (CSR) risks are number eight and number nine respectively. I should also point out the close correlation between all these risks, which makes the combination of them potentially even more damaging for businesses if they are not appropriately addressed. A series of new regulations have just been brought in or are on the drawing board. Their impact is difficult to quantify, but it is indisputable.

Examples of new regulation impact on corporates:

#	Type	Direct /Indirect Impact	Costs	Technical	Admin	Impact
New/Revised						
1	IAS 7	Direct - Indirect	C	T	A	-
2	OTC derivative	Direct - Indirect	C	T	A	-
3	IFRS 9	Direct	C	T	A	+ (-)
4	Basel III	Direct - Indirect	C			=
5	EU 8th Directive	Direct	C	I	A	-
6	Dodd-Franck Act	Direct	C	T	A	-
7	CSR/environment	Direct	C		A	(+)/-
Existing						
8	SEPA (PSD)	Direct - Indirect	C	T	A	±
9	Sarbox (SaS 70)	Direct	C	T	A	-
10	MiFID II	Indirect	C	T	A	-

IMPACT OF THE NEW REGULATIONS:

(1) Impact of OTC (Over-The-Counter) derivatives

The reform of the over-the-counter type derivatives is very much a symbol of the potential restrictions (even though treasury managers may have fought to gain exemption) that new regulations may bring to bear on businesses. Indeed, without exemption for "corporates", the potential cost of margin collateral to cover possible negative mark-to-market revaluations would be huge. It would be a heavy burden on firms who would be obliged to lock up lines of credit or cash to cover the eventual close-out of the derivative financial products being dealt in. For some businesses that deal in several times their annual sales figures, the cost could amount to several million. That would mean that we would be replacing credit risk with liquidity risk. This might in fact oblige some companies, as with IAS 39 since January 2001, to change their approach to managing financial risks to one of leaving more risks "open". Regulations that might be a good thing as a whole but unfair to corporates

might ultimately have an adverse effect on banks themselves, since they would have fewer derivative transactions to deal in. The use of central clearing houses (CCPs) also has a cost. However, even if we assume that the outcome is favourable for treasury managers, the cost of hedging will increase in the future. If the banks do not call on the front door, they will still try to get in through the back door, wanting bilateral CSA type collateral agreements. By whatever means, the banks will increasingly pass on the credit risk that they bear in hedging transactions. The longer and further away the hedge is, the greater the cost will be, to reflect the credit risk borne by the bank. The impact will therefore be in administrative, structural and financial costs borne by businesses.

(2) The impact of IAS 7 on money market funds (MMFs)

The proposed IASB amendments to IAS 7 and the concept of "cash equivalents" have been resurrected and as a result are worrying the IMMFA and many investors. Indeed, if the reforms under consideration actually happen, MMFs would be excluded

(at least at the time of the accounts close and changeover to the new accounting period). This would make it necessary to use overnight type bank deposits, to the detriment of security (concentration on a few banks instead of many MMFs) and of return (EONIA yields are lower than longer-term yields). The comings and goings into and out of MMFs at the end of accounting periods will affect MMF liquidity and also their yield itself. The additional administrative cost must also be taken into account when deciding upon future strategy.

(3) Eighth Directive or "E-SOX light"

The European Eighth Directive lays down requirements including reporting on internal control and risk management by businesses. In a way, it is our "European SOX". Companies are ever more closely scrutinised by investors, especially in certain sectors. This compliance requirement must however not endanger the capacity for innovation and creativity. The complexity in this area is becoming such that CCO (Chief Compliance Officer) type functions have developed even in non-financial businesses. The risk in terms of regulation is the diversity and divergence from one country to the next or even from one continent to the next. Without harmonisation and standardisation, there is a high risk of relocating for regulatory reasons (on top of tax, wage and cost of production reasons). For example, the law on data protection in the USA is dissimilar to what is done in Europe. This could lead to relocation out of a country that is "unfriendly" and inflexible, talking in terms of legislation. The trick for CFOs is to conduct their business in a compliant manner while at the same time ensuring it stays efficient and profitable. Compliance has a very heavy cost, and is not painless. Unfortunately these new regulations are only responses to financial deviations or innovations that were often (too) sophisticated and quick.

The absence of as severe criminal penalties as in the USA is also reassuring, but by no means lightens the burden laid upon the CEOs and CFOs who are liable. The report on internal controls and risk (ERM) will become mandatory and will involve additional time, energy and cost, particularly for the necessary automation of procedures that it implies and for bringing in effective controls.

(4) Basel III impact

It seems we still have a heavy cross to bear on the long, hard road to Basel III (B3). Nevertheless, it is clear that the new standards will have an indisputable impact on businesses, generally on the smallest (SMEs) and medium-sized (mid-cap) ones. As for the final impact, no one can quantify it. Neither can anyone deny it, though. The paradox arises from the appetite of certain banks, which cut margins at the risk of making it seem as though everything had gone back to what it was before (the 2008 crisis). This is obviously wishful thinking, and we need to distance ourselves from it. RAROC levels of less than 5% are unsustainable in the medium term. To achieve their objectives, the banks must acquire additional liquid assets (€1 billion), build up so-called "stable" portfolios of medium/long term credit (€1.7 billion) and increase their equity by the equivalent of three times 2009 annual profit. This is a big challenge for the banks, and the bill will have to be paid sooner or later by everyone, to varying degrees. In Christian Noyer's opinion, this will mean that prudential requirements will multiply by a factor of 6 to 7. The result is that the cost of credit cannot stay cheap. The BIS estimated the cost of one additional point in the liquidity coverage ratio (LCR or "Bear Stearns Ratio" and the NSFR) as being a 1.5% fall in lending capacity and at 12 to 15 basis points on credit margins. That's all! Cross selling and side business will therefore become the lubricant essential to banks'

profitability. The biggest banks will have the advantage because they have the widest range to offer. The FSA, the UK regulator, considers that banks in the UK have too much leverage. Competition will therefore be fiercer and the banking services used by businesses will be too scarce to meet everybody's requirements. The paradox here is the need to provide more ancillary services, without growth in them. This is a real dilemma for treasury managers in their allocation of ancillary business.

The banks may be expected to handle their investments and cash. We can imagine the scenario of sovereign states, with deep budget deficits, borrowing ever greater amounts, threatening to exhaust the banks' capacity on the capital markets. In theory, the capital markets could certainly absorb part of the decrease in bank lending (as in the USA where the proportion is more evenly balanced by comparison to bank lending). However, the arrival *en masse* of sovereign states will cut down this absorption capacity considerably. The charges for credit, particularly syndicated credit and other committed lines will rise to (partially) offset the banks' additional borrowing costs and the B3 restrictions. The cost and the terms will become ever stricter. Spreads will widen between credit ratings and from industry to industry. Clearly, the bank lending/capital markets ratio will be more evenly balanced (as in the USA), but standby credit will be more expensive.

Nobody would suggest that only small companies and low ratings will suffer. The risk will then be of marginalising a chunk of the economy, and no small chunk either, if we think of countries like Germany. The banks will have to seek and find profit from somewhere. The risk of overselling will inevitably arise. Only the big banks would be able to offer a variety of products to offset the potential loss of revenue. The corporate and the banking world are at risk of splitting

into two completely different hemispheres. There could also be a USA/Europe split (in which Europe would not necessarily be the winner). The "real economy" could only suffer.

Furthermore, Basel III would also have an indirect impact on MMFs through its impact on very short-term investments. Secure and liquid products with yield will become impossible to find, making it more complicated and risky for businesses to manage surplus cash. Short-term deposits will pay less interest because they will be less sought-after by banks than long-term deposits. Off-balance-sheet products will also become less attractive. With the new stress tests and Basel III, we may also fear a new wave of mergers and concentration in the banking industry. This is never good in terms of credit because one plus one seldom make two under these circumstances.

(5) Corporate governance

Over and above the many regulations and the other national legislation framing corporate governance, the European Commission (EC) has just initiated a huge public consultation. After some years of the principle of self-regulation, the EC has decided that it is essential that companies should be better managed to reduce risk and to improve competitiveness. This "green paper" attempts to define methods for improving corporate governance (for example diversifying Boards of Directors, improving the way they operate, involving a greater number of shareholders, improving the quality of governance reports, measuring performance, enhancing minority shareholder protection, ensuring long-term profitability, identifying shareholders, etc.). Responses are due by 22/07/2011. According to the Commissioner M. Barnier, we need more responsible and more sustainable companies. Excessive "short-termism" has unfortunately had

regrettable consequences on the state of economies throughout the Western world. Shareholders must now shoulder their responsibilities fully, and to do so they will turn to their natural point of contact: the CFO. The European Commission aims to achieve better supervision of the finance industry, to have more robust banks and effective resolutions for bank failures. It also aims at improving the way that all businesses in general work.

(see: http://ec.europa.eu/internal_market/company/modern/corporate-governance-framework_en.htm).

(6) Sustainability

Sustainability will become a mandatory objective for companies in the very near future. Special reports will also become mandatory and, even although they may not be financial, why should they not be incorporated into one single report (see the "one report" concept developed by Professor R. Eccles of Harvard University). The financial and non-financial performances are so bound up with each other that both should be included in a single cohesive and consolidated report. That is the future in terms of sustainable development reporting requirements, there can be no doubt about it. It will be done either through the IFRS rules (which would venture some way beyond the accounting and financial framework) or through organisations such as the IIRC (the "International Integrated Reporting Committee"). What is done on a voluntary basis today will be mandatory tomorrow. And, as for accounting results, standardisation will provide the necessary comparability. There are cross-linkages between the financial, environmental, social and governance factors, all of which act together to promote long-term performance (for example, mandatory in South Africa – see the AXA, BASF and Novartis reports). Businesses will have to explain how they

allocate human, financial and natural resources to achieve their financial and non-financial objectives. The goal is to get into the "sustainability" stock market indices (for example the *FTSE4good index*) or meeting Bloomberg's or Reuters' requirements on the matter. This "integrated report" idea was on the agenda of the last G20 in Paris. We also have to build "green" buildings, reducing CO2 emissions correspondingly and demonstrating the fact, we have to reduce our energy consumption and to report this under CSR (Corporate Social Responsibility – see the ISO 26000 standard). Anything that is not imposed by law will be imposed by the course of events and by good practice in financial reporting. The CFO must further, amongst other "soft skills", develop his ability to communicate effectively, even on non-financial subjects.

Conclusions

The imposition of all these new regulations is unwelcome in an economic climate that is, to say the least, in disarray. For example, there is uncertainty on sovereign debt and abyssal government borrowings, on inflation and stagflation, hyper-volatility in currencies and currency wars, the surge in commodity prices and that of oil in particular. We cannot make reference to all forthcoming regulations, but let us revisit the impact of the "EU Green Paper" on external audit. Who can say what impact such regulations will have for finance departments? Furthermore, these regulatory challenges will require increased use of technology to achieve compliance. This will involve additional cost. Competition between banks will become yet fiercer. They will keep on merging to withstand it. They will have to adjust their prices to fight off new entrants, as for example in the field of payments (see PSD Dec. 2007 – SEPA). To end on an optimistic note, it is through adversity that we will finally progress towards better

corporate governance; but at what price? That is the real question to bear in mind. The CFO and the treasury manager are caught between a rock and a hard place: on one side the growing uncertainty that surrounds the economic environment and on the other there are regulations that are ever more restrictive. It will be a tight squeeze to get through. The trick is in managing the risk/cost/value equation. The regulatory background and the constraints are growing unceasingly and affecting the finance function as a whole. We have given a few examples (not comprehensive) which illustrate the risks and the potential impact, whether financial, organisational, administrative or in terms of cost. There is only so much that you can do, and if you try to impose too many restrictions by law, you risk stifling businesses either directly or indirectly. And what is more, it is not always the biggest or the most robust who will be hit hardest. The problem with regulations arises from the lack of worldwide coordination. The economy is global while regulations are still only national or continental. There is a major risk of divergence, which inevitably leads to relocation choices dictated by legal systems. These rules are also too isolated, fragmented and make up a really messy patchwork. Regulators often try to go too far. The pendulum has swung too far the other way in response to past excesses. Ideally, we would like to see these regulations being principles-based rather than rules-based (for example IFRS 9). However, principles may sometimes not be enough. Too much regulation can also lead to box-ticking, which is inefficient and ineffective. New supervisory authorities are being set up such as ESMA ("*European Supervisory Markets Authority*"). Too many rules are self-defeating and risk eventually impeding cross-border transactions. But it is anarchy that we have to face up to right now. It is coming at us from all sides, without counting local markets supervisory

authorities such as the AMF or the FSA, etc)...

Another recent PwC survey of CEOs confirms that the risk of over-regulation is number three (of the top 10), behind the risk of economic recession and abyssal public deficits. This shows that in spite of the current impact or the currently-known potential future impact, managers are still fearful of new regulations being taken to extremes and the implications of this for running businesses ("*PwC 2011 – 14th annual global CEO survey*"). This risk has incidentally been in the top three since 2008. This proves that they perceive the risk of new laws that are yet more restrictive for companies. Even though no one would dare to dispute the G20 aspirations for greater transparency, everyone fears having to expend more energy in producing new reports or in complying with principles that have become mandatory. Going too far ruins everything. Through excessive legislation we may end up having to spend all our time on compliance rather than seeing to our core business. As Emile Zola said: "I hate people who foolishly try to make today's truth out of yesterday's truth. They do not realise they are on the move, and that the landscape around them is moving too". Is this not the main challenge for today's CFO who have to, and who will keep on having to, adapt to the impact of these ever-proliferating regulations?

ALFI-PRIM'S RISK MANAGEMENT GUIDELINES ON RISKS RELATED TO OUTSOURCING

Graham Goodhew, Chairman, ALFI Working Group on Operational Risk; Director and Conducting Officer, JP Morgan Asset Management

Thomas Nummer, Co-Chairman of the ALFI Risk Committee, PRiM Board Member; Managing Director, Carne Group



Graham Goodhew



Thomas Nummer

The full paper can be downloaded from ALFI's web site (<http://www.alfi.lu/publications-statements/publications/alfirisk-management-guidelines>)

Risk management has become a dominant topic in a number of recent regulations. Whereas in the context of UCITS IV risk management has been confirmed and clearly expanded beyond the traditional focus on market risk, the current consultation on AIFMD level II measures shows clearly that ESMA expects also a broad concept of risk management that will be one of the core functions of an alternative investment fund manager (AIFM).

In order to develop further the risk management procedures/standards in Luxembourg, the members of ALFI and PRiM work together closely. The ALFI working groups on market, credit and counterparty, liquidity risk and operational risks address key risk categories as outlined by the UCITS IV Directive and its implementing measures.

The Working Group on Operational Risk has developed guidelines on how to manage the risk related to outsourcing/delegation, in order to assist market players in the pragmatic operational implementation of these regulatory requirements. Below we have summarised some key aspects of these guidelines.

Summary of the paper

The goal of the document is to share within the Luxembourg investment fund industry "best practice" standards for management companies and investment companies, i.e. self-managed SICAVs, ('ManCo') when delegating services to third parties.

There are different levels/degrees of outsourcing by a ManCo that are possible. Luxembourg ManCos delegate several functions to third parties, including group companies, which include: transfer agency, fund accounting and administration, investment management and marketing &

distribution.

In addition the Commission Directive for UCITS IV allows for an appropriate and proportionate view to be taken on the provision of Risk Management, Compliance and Internal Audit functions, which may include the outsourcing of these functions to external expert providers or internal group company centres of expertise. When delegating certain of its functions to a third party, the ManCo always retains the ultimate legal responsibility for the outsourced functions.

What are the key pillars to manage your delegations adequately?

Classification of outsourcing relationships

Each ManCo shall have at any time a comprehensive overview of all outsourcing relationships. Depending on the business model of the ManCo, a large variety of different services may be outsourced. Therefore a distinction should be made between different types of outsourcing relationships, i.e. material or non-material, depending on the risks associated with the outsourced function and the delegate.

Manage your delegations over the whole lifetime

Any outsourcing relationship can be characterised by three distinct phases.

(1) Initiation Phase – Due Diligence

All delegations should be subject to appropriate due diligence (prior to the delegation) and legal documentation (in the form of a signed agreement). It is the responsibility of the board of the ManCo to ensure that only delegates who are suitably qualified and have the required level of professional expertise are appointed to perform functions on behalf of the ManCo. Having identified a selection of service

providers who meet these requirements, it is good practice to request the completion of a 'Request for Proposal' ('RFP') in order to identify a list of candidates on whom detailed due diligence will be completed.

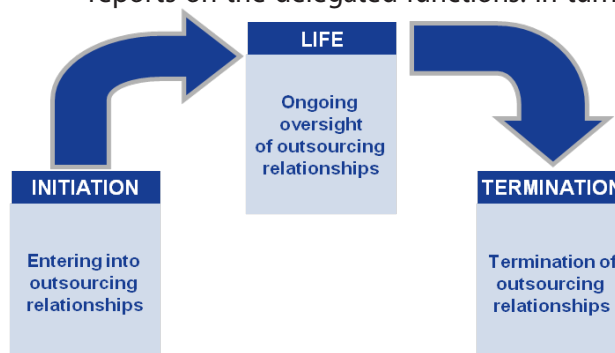
The objective of a due diligence process is to determine whether, having regard to the functions to be carried out by the delegate, the potential delegate can be considered as qualified and capable of undertaking the outsourced functions.

The relationship between the ManCo and the delegate should be governed by a legal agreement duly signed by both parties. Besides the legal agreement, it is recommended to detail further the service scope in an additional service level agreement (SLA) or operating memorandum (OM) to be entered into with the delegate.

(2a) Life Phase – On-going Delegate Monitoring

The board of directors of the ManCo is ultimately responsible for ensuring that an effective monitoring system is in place for all material outsourcing arrangements. The structure and governance of the on-going monitoring of delegates may vary depending on the structure of the ManCo (e.g., size, internal organisation, degree of risk involved in the delegated activity, etc.).

Conducting officers ('CO'), to whom the investment company or management company's board has entrusted the day-to-day operation of the fund receive regular reports on the delegated functions. In turn



the CO (or their delegates) report to the board of the SICAV and the management company.

The ALFI paper gives some examples (simple, middle and sophisticated structure) on how an on-going oversight can be structured depending on the structure of the ManCo and/or the complexity of the fund/business. For example, a 'Middle Structure':

- Responsibility for on-going delegate monitoring and reporting is assigned to the different department heads who would be in charge of the delegated function.
- Management committee (or similar) that would comprise, for example, the conducting officers and heads of departments will meet regularly (e.g., monthly)
- On a quarterly basis (minimum) the COs would report to the board on the performance of the delegates.
- Responsibility for interfacing with the custodian and external auditors on behalf of the SICAV board is often given to specific departments that will report

to the CO.

(2b) Life Phase - Reporting

Reporting on outsourcing relationships and the related controls performed by the ManCo should be provided on a regular basis to the responsible person/committees (depending on the internal structure of the ManCo).

Reporting is basically at two levels:

- Agreed regular reporting from each delegate to the CO or other function within the ManCo that is responsible for the oversight, and
- Periodic reporting from the CO, or other functions, to the management committee and subsequently to the board of the ManCo.

(3) Termination Phase

If an outsourcing relationship is terminated, either by the ManCo or the delegate, the board of the ManCo must decide whether to:

- Bring the function back in-house,
- Appoint a new delegate, or
- Discontinue the function as it is no longer required.

Conclusion

The ALFI paper has been well received by the market participants and the working group has received very good feedback from members who have used the examples to benchmark their existing procedures. But do not forget: The paper is merely a best practice guideline and each ManCo/Sicav needs to come up with its own procedures that fit its business model.



REGULATORY RISK CONFERENCE

Organised by ATEL, PRiM & PRMIA Luxembourg

On October 6th 2011 at the Hotel Melia, Luxembourg, Richard Raeburn, Chairman of EACT (European Association of Corporate Treasurers) and Anthony Kirby, Director, Regulatory Reform and Risk Management, Ernst & Young came to discuss the regulatory risk issues facing both corporates and the financial sector in the coming years.

Particularly refreshing was the opportunity to hear the corporate perspective on the what Richard Raeburn called the "alphabet soup of regulations" (FASB, IASB, FATCA, MAD...). The demands placed upon European politicians, who can pass from relatively banal food regulatory concerns to major systemically important and complex financial rules, are clearly a step too far. Specific examples of occasional hair-raising incomprehension from the part of political representatives were shared to put this in perspective.

Richard stressed the importance of the professional lobbying required from the corporate sector, who are often overshadowed by the much more determined lobbyists of the banks. The result of efforts so far - citing the EACT actions - appear to have made some progress along improving the levels of understanding within the European institutions.

One area of great concern is the understaffing of ESMA (European Securities and Markets Authority), who face immense pressure to hit the politically set deadlines, regardless of the fact that many proposed regulations require greater analysis and the potentially far-reaching consequences thought through with input from industry technicians.

So what lessons have been learned so far by EACT?

1. Brussels is a difficult counterpart to deal with, that it is full of lobbyists all vying for their own agenda to be heard.
2. Business Europe¹ has proved largely ineffective in defending the corporate interests against the more powerful, more organised banking sector.
3. That politicians simply often are not hearing the voices of the corporate sector

Anthony Kirby acknowledged the frustrations experienced expressed by Richard Raeburn, going on to say that the financial sector also shared deep frustration over the fact that the regulatory response to financial crises never prevents the next crisis. Indeed, one of the more alarming consequences of the current tsunami of regulations is to introduce ever greater correlation risk.

He explained that the 2008 crisis was the "perfect storm": risk management practices lacked understanding of risk / reward dynamics, failed to challenge poor assumptions, created flawed incentives and through reporting silos missed correlation risk; markets lacked transparency, relied too much on rating agencies and permitted complex and often opaque products to proliferate; regulators failed to have systemic, co-ordinated oversight of all markets, tolerated weak capital and liquidity standards.

The response? The G20 is compressing 10 years work in to 14 months...!

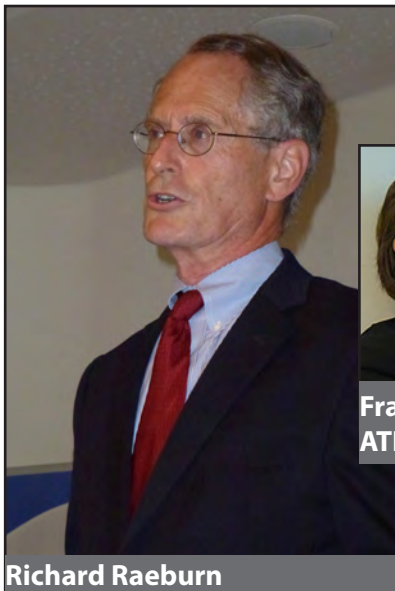
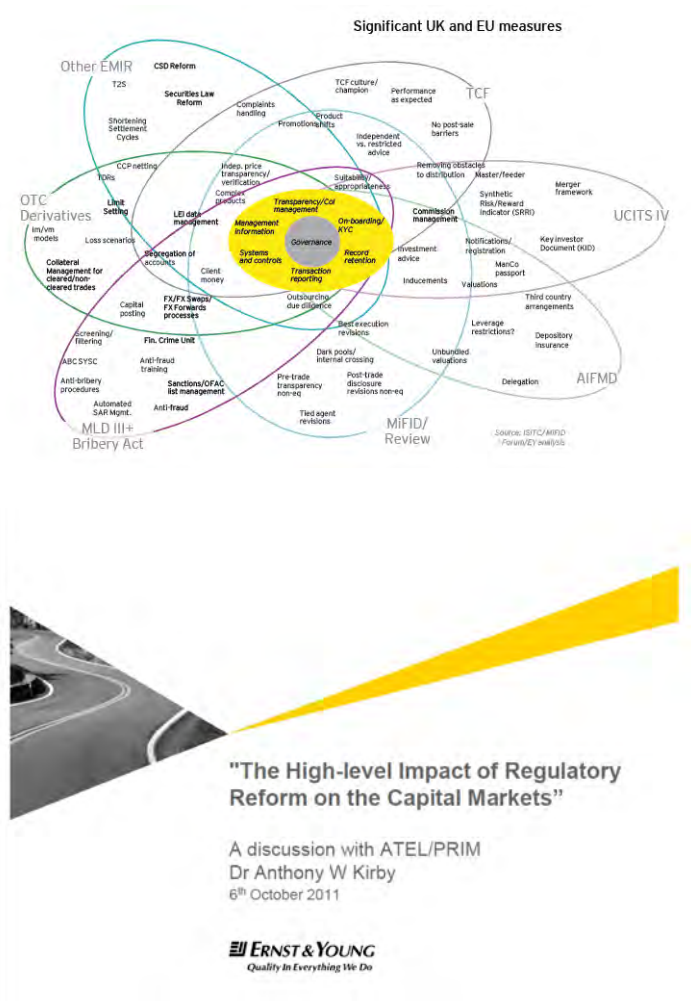
The new question is whether the response can be adequate. Developing risk tools and techniques are critical but have yet to be proven - the danger in many areas is that only the largest will survive, which will thus increase risk through concentration.

¹ The main horizontal business organisation at EU level, with 41 member federations representing 20 million companies from 35 countries

Costs are climbing steeply with little sense of any filter being applied to allow attention and effort to be directed towards the absolute priorities. What can we do LESS of? What can we do better?

There is a shift from Directives to Regulations (where there is no possibility of change), removing any scope for softening impacts where they are clearly inappropriate.

Sadly, the evening could not conclude with any recipe for what both speakers felt was a much-needed rational evaluation to counterbalance the political agenda, however valid the sense of urgency of dealing with the 2008 "perfect storm". Yet both speakers raised awareness and spoke eloquently of the issues facing both corporates and financial sector professionals in the months and years ahead. Without the slightest doubt, business models are going to be challenged fundamentally, whether the regulations prove ultimately to be right or not.



Richard Raeburn



François Masquelier, ATEL



Anthony Kirby,

Marco Zwick, PRiM

PRiM News

PRiM SCHOLARSHIP 2012

The PRiM Risk Management Scholarship was awarded for the first time in 2010. It actually comprises two scholarships of € 3,000 each – One for students enrolled in the Luxembourg School of the Finance, the other for participants in the PRiM/IFBL training programme Financial Risk Management, which is taught by Professors Hübner and Jorion.

The scholarships are awarded on a competitive basis. To compete for the scholarship, applicants must submit an essay in English and in MS-Word format with a maximum length of 2,000 words. The scholarship is paid in the form of a reimbursement of fees for the Luxembourg School of the Finance or the PRiM/IFBL training programme Financial Risk Management. The money awarded may not be used for any other purpose. Winners are chosen by the PRiM Board of Directors and all decisions made by the Board are final.

The essay topic for the 2012 PRiM Risk Management Scholarship is: *The financial crisis was a clear demonstration of how globalisation has contributed to increasing the level of systemic risk in financial markets. Please explain systemic risk and how it impacts contemporary financial markets. In your answer, please provide examples and ideas of how systemic risk can be managed effectively.*

The deadline for submitting an essay to compete for the 2012 scholarship is February 26, 2012. If you have any questions on how to submit an essay for the scholarship competition, please send an E-mail to: info@prim.lu. Please mention "PRiM Scholarship" in the subject line and provide your complete contact details in your E-mail. Good luck!

PRiM/IFBL CERTIFIED TRAINING PROGRAMME IN RISK MANAGEMENT

PRiM and the IFBL, the Luxembourg Institute for Bank Training, have designed a certified training programme in risk management, which they are planning to launch in 2012. To receive the "Risk Management Specialist" certificate, which will be issued by PRiM, candidates must complete nine days of training courses and pass the exam for each course. All the courses are being developed and will be delivered by trainers who are appointed by the PRiM/IFBL Cercle de Qualité Risk Management (Risk Management Quality Circle).

The target audience for the certified programme is not only risk managers, but also professionals and managers from other areas in financial services, who want to acquire a solid understanding of risk management. For current and future risk managers, the programme can serve as a good preparation for an international risk management certification, such as GARP.

The training programme aims at covering the following topics in risk management:

- Fundamentals of Risk Management
- Measuring and Managing Market Risk
- Measuring and Managing Operational Risk
- Measuring and Managing Credit / Counterparty Risk
- Measuring and Managing Liquidity Risk
- Risk Management in the Investment Fund Industry
- Asset and Liability Management
- FRM Mathematics, Probabilities and Statistics
- Mastering Advanced Techniques and Complex Issues in Risk Management

The programme is still being developed by PRiM and the IFBL. We will provide more information as it progresses.

NEXT EDITION: January 2012

THEME: Alternative Funds

CONTRIBUTORS WELCOME