

Global Risk Watch Newsletter

Chinese Economy – Becoming Uncontrollable?, etc.

Global Risk Watch Vol.5
31 August 2015

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<<index>>

- [1. # Chinese Economy – Becoming uncontrollable? \(Tsuyoshi Oyama\)](#)
- [2. # Risk Appetite Framework is re-emphasized \(Koichi Iwai\)](#)
- [3. # Creeping Deflationary Risk Approaches the Chinese Economy \(Koichi Iwai\)](#)
- [4. # Increasing Global Population and its impacts \(Hitoshi Motegi\)](#)
- [5. Seminars](#)

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2. Overview of Development in Financial Regulations (Trends & Topics)

Risk Appetite Framework is re-emphasized (Koichi Iwai, Senior Manager, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Basel Committee on Banking Supervision (BCBS) has successively published two important documents regarding Risk Appetite Framework (RAF). The first is the revised guidance on 'Corporate Governance principles for Banks', which literally shows the principles (criteria) to be satisfied by the corporate governance of banks. This revised guidance is set to replace the one published by BCBS in 2010.

Comparing the revised guidance with the 2010 version, clarification of the roles of the board of directors and a strong advocacy for the application of RAF were the distinctive differences. Moreover, this revised guidance explicitly indicates the responsibilities of the Board of Directors as follows:

- 1) Establish and be satisfied with the bank's organisational structure;
- 2) Play a lead role in establishing the bank's corporate culture and values;
- 3) Establish bank's risk appetite along with senior management and the CRO;
- 4) Oversee the bank's adherence to the Risk Appetite Statement (RAS), risk policy and risk limits;
- 5) Oversee the bank's approach to compensation and assess whether it is aligned with the bank's risk culture and risk appetite;
- 6) Oversee the integrity, independence and effectiveness of the bank's policies and procedures for whistleblowing;
- 7) In discharging these responsibilities, the board should take into account the legitimate interests of stakeholders.

In addition, it should also be noted that the revised guidance has referred to operational methods of RAF. For example, the application of both top-down and bottom-up approaches during the development of RAF and the usage of three lines of defense are set out as requirements. Meanwhile, the word 'Appetite' has been used 18 times in the 2010 guidance, and 43 times in this revised guidance. Furthermore, the revised guidance could be regarded to be quite ambitious because a description regarding Misconduct has been newly added to the requirements. Chairman of the Japanese Financial System Council has already indicated the necessity to incorporate the content of this revised guidance into relevant rules to proceed the strengthening of banks (holding companies) governance. Therefore, Japan should see more active debate of greater use of RAF in the near future.

The second document is a report on impact and accountability of bank supervision. This report presents a range of practices on how supervisors around the world define and evaluate the effectiveness of its own administration, and how they fulfill their accountability to stakeholders such as government and parliament. One of the recommended traits of supervisors is to 'transform' regulatory goals into specific supervisory practices and achievements. Although this report does not refer to this approach as RAF, the content itself mentioned 'top-down and bottom-up process', 'use of three lines of defense', and 'clear dialogue with stakeholders', which seem to follow the concept of the RAF. In this sense, this report corresponds to the recent proposal by the Financial Stability Board (require supervisory authorities to set its own risk appetite, illustrated in the Global Risk Watch Newsletter Vol. 3).

Looking at these recent developments, RAF is expected to be commonly used by banks and supervisory authorities.

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