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Association Luxembourgeoise de Risk Management

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Welcome!

The phrase "corporate governance" is often mentioned in discussions on financial risk management, particularly since the Financial Crisis of 2008. The radical changes that affected financial institutions at that time became symptomatic of issues that impact all corporate entities, regardless of the economic sector to which they belong. For this reason, the present issue of the *ALRiM Risk Newsletter* considers corporate governance in a wider perspective that transcends financial services alone. Recent developments in corporate governance have clearly demonstrated that all corporate entities share similar concerns about transparency, integrity, responsibility and communication among corporate bodies, particularly boards of directors.

In that context, this issue of the Newsletter includes interviews with three experts from different areas of corporate governance: **Claude Simon, Director and Member of the Executive Board of the Commission de Surveillance du Secteur Financier (CSSF); Marie-Jeanne Chèvremont, President of the Institut Luxembourgeois des Administrateurs (ILA)** and **Dan Konigsburg, Managing Director Corporate Governance and Public Policy, Deloitte Touche Tohmatsu Limited, New York.** To ensure consistency between the three interviews, we have used similar questions in all of them. Also included below is an article on product governance by **Ravi Beegun, Partner, KPMG, Luxembourg,** and a **Member of the ALRiM Board.**

It is clear from the following interviews that the importance of corporate governance will continue to increase in the future. Risk management will certainly play a key role in this development, meaning that the two disciplines are inextricably linked together.

Any ideas for future issues of the *ALRiM Risk Newsletter* or any comments that you have are always welcome. Please send them to: info@alrim.lu.

Bonne lecture!
Paul Kleinbart, Editor

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Interview: Corporate Governance from a Regulator's Perspective

Claude Simon, Director and Member of the Executive Board of the Commission de Surveillance du Secteur Financier (CSSF)

Extremely important for corporate governance in the Luxembourg financial sector are the views of the CSSF. We therefore are fortunate to have had the opportunity to interview **Claude Simon, Director and Member of the Executive Board of the Commission de Surveillance du Secteur Financier (CSSF).** Following are Mr Simon's responses to our questions on corporate governance.

ALRiM: Corporate governance, risk management and compliance are closely associated. What is your view of the relationship between the three disciplines?

Claude Simon (C.S.): If corporate governance is the complete and finished painting, risk management and compliance are key structural elements of it. There can be no adequate corporate governance without a well-integrated risk management and compliance.

Integration is the key since too often people tend to look at (corporate) governance as something happening at the top of the organisation, whereas risk management is considered as something happening at operational levels.

Risk management and compliance need to interact horizontally and coordinate their work to make sure there are neither unproductive overlaps, nor control gaps between their respective areas of responsibility. The precise distribution of responsibilities that could be part of either risk management or compliance may vary. Of greater importance is the vertical interaction between the board and management, on the one hand, and the risk and compliance functions on the other.

For one, governance should not be considered as being the sole responsibility of the decision-making bodies at the top of an organisation. Adequate governance needs to be rolled out horizontally and vertically across the whole organisation. Second, it is of critical importance for successful governance that risk management and compliance considerations are taken into account not only at the day-to-day, operational levels, but also at board and management levels, where the strategy setting and decision making processes originate.

ALRiM: The focus on corporate governance, particularly in financial services, has increased considerably in the last ten years. To which factors would you attribute that trend?

C.S.: The focus over the last 10 years has foremost been on failures of corporate governance. Significant events, be they systemic (e.g., financial crisis) or idiosyncratic (e.g., corporate fraud), have triggered responses in the form of legislative initiatives and supervisory measures to prevent similar events from reoccurring. At the same time, these events receive, also because of new media, a much broader public scrutiny than used to be the case some decades ago.

Examples of significant failures are to be found in the corporate accounting scandals of the early 2000's, as well as the recent financial scandals and cases of misbehaviour (e.g., LIBOR manipulation scandal, mis-selling of financial products, rogue trading, etc.).

The increase in such failures is usually attributed to the imbalance between risk-taking and risk avoidance, as well as between remuneration and ethical behaviour and the failure of companies' boards to effectively balance these forces properly.

Aside from the enhanced media scrutiny, the ensuing process is not new then: The perception, conviction or evidence that something is not going well or needs to be improved generates a broad consensus about the need for reform. Regulation, including self-regulation, is shaped through this process.

ALRiM: Recent changes in corporate governance have raised numerous questions about accountability, integrity and communication. What would you see as the most important issues in corporate governance today?

C.S.: Accountability and legal responsibility existed long before the corporate governance concept was born. Adequate communication, integrity and ethical behaviour are values that have long ago become part of listed companies' published best practice codes across many industries.

"Regulation is not an end by itself. It is a means to an end. It is triggered by identified needs, the occurrence of certain events like abusive behaviour, unmeasured risk-taking."

As mentioned before, the key challenges in corporate governance today are linked to the relations between risk-taking and risk avoidance, between remuneration and ethical behaviour being out-of-balance. It is the board's responsibility to ensure that an adequate balance is maintained between the opposite forces of each of these two pairs. To achieve this balance, banks and investment firms, for example, have to review and eventually adapt their corporate governance to the recent regulatory requirements as outlined hereunder.

In more concrete terms, one must start at the top, where an organisation's strategy is defined, down to the level of departments and individuals. A board of a bank or investment firm has to define an appropriate risk strategy, including risk tolerance and to promote an internal risk culture fostering a sound and prudent risk management as well as a positive attitude vis-à-vis internal controls and compliance (see circular CSSF 12/552 as amended on central administration, internal governance and risk management). The board also has to be involved much more actively in the company's processes. Supervision, which conveys a rather passive attitude, gets the meaning of assurance, signalling a much more active involvement.

For banks and certain statuses of investment firms, this approach requires directors to be fit and proper. Whereas in the past directors only had to fulfil the condition of good repute, they are now required to be also fit, i.e., to have the necessary level of knowledge, experience and competencies. The new prudential requirements also imply for each director to dedicate more time to each institution, therefore accepting less mandates. According to the CRR/CRD IV requirements, the number of mandates non-executive board members may exercise as board members of banks and certain statuses of investment firms of significant importance (due to their size, risk profile and complexity of their business and organisation) should in principle be limited to four.

Independent non-executive board members can contribute to improve corporate credibility and governance as they provide in principle a view of the company that is independent from day-to-day management. They should monitor and challenge the performance of the executive directors and the management. The CSSF recommends larger banks and investment firms to have one or several independent directors (see circular CSSF 12/552).

Similarly, control functions such as compliance and risk management have to be involved much earlier in (strategic) decision-making processes to ensure that their advice can be taken into account when setting strategies rather than only at the level of operational activities. To ensure that there is a platform for such an exchange of views, more and more institutions will need to create specialised committees. In that sense circular CSSF 12/552 recommends larger banks and investment firms to set up an audit committee and a risk committee with the purpose to assist the board of directors in their decision-making. The recommendation to create a risk committee is also addressed to those with a higher and more complex risk profile.

In the field of prudential supervision, the quality of corporate governance as well as of risk management, compliance and internal audit are covered by the Supervisory Review and Evaluation Process (SREP) of the prudential supervisory authority and is an important element of the assessment of a bank's or investment firm's risk profile. The SREP does thus not only cover quantitative aspects of risk (risk level) but also qualitative aspects like internal governance, risk management and control levels for all kinds of risk incurred.

While the preceding reflects more specifically the current evolution concerning banks and investment firms, it remains true in essence for other sectors and other corporations too.

ALRiM: Since the Financial Crisis of 2008, we have seen numerous regulatory changes aimed at addressing the issues that became apparent during the crisis. Do you feel that the current level of regulation is adequate for ensuring effective corporate governance? What changes do you see emerging in the short to medium term?

C.S.: The level of regulation we have today is a direct consequence of the events and circumstances of our time, just as each preceding level of regulation reflected the prevailing environment of that time.

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Regulation is not an end by itself. It is a means to an end. It is triggered by identified needs, the occurrence of certain events like abusive behaviour, unmeasured risk taking. It is a measure enforced to counter present and prevent the occurrence of future abuses and undesirable developments.

Current financial regulation thus reflects and is a direct consequence of the events and circumstances of recent years. While it may seem excessive or cumbersome to apply, it has to be considered in light of the significance of the financial crisis for the world economy.

This also means that it will remain appropriate as long as it achieves its goals. If it becomes apparent that its goals are not or no longer attained, there might be further qualitative or quantitative regulatory developments.

With a good measure of common sense and a focus on long-term viability and sustainability in directing and managing financial institutions, risk taking and risk avoidance as well as remuneration and ethical behaviour might become rebalanced, thus reducing the need for creating major new regulation.

Industry-wide and significant individual abuses of the financial system will continue to present a risk. Institutions' boards can largely contribute to keeping these risks in check by setting the adequate tone at the top. As previously mentioned, supervisors are following the topic much more closely now to ensure effective corporate governance.

ALRiM: How do you see the future of corporate governance? Do we need to rethink the concept of a corporate entity? In your opinion, what role should risk management play in this development?
C.S.: Corporate governance should in principle remain the realm of corporate entities. Boards have to regain control over their corporations with the assistance of, amongst others, risk management and compliance.

Risk management needs to abandon overly reliance on math, modelling and ratings and reinstate common sense and human judgment founded on adequate levels of knowledge, experience and skills.

Recently introduced regulation now needs to settle in and be integrated in an institution's day-to-day processes at all levels. Corporate and risk management values that are not lived on a day-to-day basis but serve merely as a commercial and marketing tool or as a justification towards authorities are of no value and will do little to prevent the next crisis and the next round of regulation.

ALRiM: Thank you for sharing your views with us! ●

Interview: Current Issues in Corporate Governance

To gain a good understanding of current issues in corporate governance, ALRiM interviewed two experts in corporate governance across different industries. In Luxembourg, we interviewed **Marie-Jeanne Chèvremont, President of the Institut Luxembourgeois des Administrateurs (ILA),** and in New York we spoke to **Dan Konigsburg, Managing Director Corporate Governance and Public Policy, Deloitte Touche Tohmatsu Limited, New York.**

Marie-Jeanne Chèvremont,
President of the Institut Luxembourgeois des Administrateurs (ILA)

Dan Konigsburg,
Managing Director Corporate Governance and Public Policy, Deloitte Touche Tohmatsu Limited, New York

ALRiM: The focus on corporate governance, particularly in financial services, has increased considerably in the last ten years. To which factors would you attribute that trend?
Marie-Jeanne Chèvremont (M.-J.C.): Even before the Financial Crisis of 2008, there was considerable interest in corporate governance, which was accompanied by many regulatory changes. The Financial Crisis accelerated this trend by raising numerous issues linked to corporate governance. Particularly the losses suffered from the Crisis caused both financial and non-financial companies to raise questions that they had not asked before. One of the key issues to arise in that context was the question of responsibility, particularly regarding the roles of shareholders and directors. No matter what the corporate structure, it is essential that both shareholders and the market in general know who is responsible for a company and its performance.

Dan Konigsburg (D.K.): Attention paid to corporate governance is often driven by scandal. So I have a sense it will always remain current. The Financial Crisis of 2008 certainly had a significant impact on corporate governance and regulation, which pushed change in the financial services industry. We only need to look at the impact of the Dodd-Frank Act in the U.S. or MiFID in Europe to see how regulation pushes corporate governance. A particularly important trend in recent times is the increasing focus on directors and their responsibilities. Although it is primarily supervisors who are driving this trend, sophisticated investors are also an influential part of it. In this context, the Financial Crisis of 2008 actually may have played a small part, because it caused people to think differently. The Crisis clearly demonstrated the interaction between all types of companies, not just the financial sector. Corporate governance is viewed differently in each country: In Europe, the focus is more on society and people, whereas in Asia governance maybe seen as a tool for competitiveness.

ALRiM: Recent changes in corporate governance have raised numerous questions about accountability, integrity and communication. What would you see as the most important issues in corporate governance today?
M.-J.C.: In corporate governance, it is clear that the board of directors is accountable to the company and to all stakeholders for the performance of the company. A board has a collective responsibility, but it delegates this accountability to the CEO for the everyday operation of the company. The shareholders need to understand their responsibility for appointing the appropriate people to the board of their company. Today there is considerable focus on the personal responsibility of each director.

D.K.: All three are very important. For me, the biggest issue in corporate governance today is the level of oversight provided by the board of directors. While on the one hand, boards provide oversight of risk through the presence of risk committees and audit committees, shareholders are becoming increasingly demanding with regard to the level of disclosure and transparency of publicly listed companies. A lot of this shareholder activism is coming from Europe, whereas in the past it was primarily an American concept. There can be an argument for activism at times, particularly in extreme cases where a company may be badly managed. But shareholder activism cannot be unlimited. The regulators have a role to ensure that the effects of shareholder activism do not harm companies or the market.

Some of the broader corporate governance issues that exist outside of individual companies, but have a significant impact include: the

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sometime short-term focus of shareholders and managers; the fragmentation of markets and the fragmentation of trading.

ALRiM: Since the Financial Crisis of 2008, we have seen numerous regulatory changes aimed at addressing the issues that became apparent during the crisis. Do you feel that the current level of regulation is adequate for ensuring effective corporate governance? What changes would you recommend or do you see emerging in the short to medium term?

M.-J.C.: Personally, I think that the current level of regulation is adequate. The problem is how we understand and apply the existing regulations. Most of the issues on which we focus today were already foreseen in Luxembourg's traditional company laws. The problem is not so much the laws, but their application. If corporate boards and managers would apply the laws as they were intended, i.e., not just by the letter, but by the spirit as well, then we would certainly have less issues in corporate governance. If we had only applied the existing laws correctly, then additional regulations might have been unnecessary.

"Transparency is a key concept in this context and it is becoming increasingly important. But finding the ideal balance between transparency and privacy will be a major challenge for the future."

Marie-Jeanne Chèvremont

One serious threat in this regard, however, is the current tendency among directors to take on too many mandates. At present, there is no limit on the number of mandates that a director may have. This trend is particularly problematic for director mandates in the investment fund industry, which require a high level of expertise. ILA has prepared guidelines on accepting mandates, which include advice on the appropriate time and appropriate experience required to fulfil each mandate.

I think that we do not need more regulations, but perhaps more expertise. For this reason, ILA also provides training courses for all types of directors. We probably need to develop our understanding of business and business practices, which include questions about audit, risk management and compliance.

D.K.: I would not consider myself to be an expert in financial services, however we see evidence that financial institution boards - as well as other types of companies - are less focused on regulation than before and are spending more time managing risk than in the past. Deloitte recently conducted a survey of directors from over 20 countries and found that the percentage of directors interviewed who rated regulation as 'very high' on the boardroom agenda dropped from 41% to 32% in the previous year. The OECD is updating its principles of corporate governance to focus more on risk for the first time, which is indicative of a greater focus on risk. One thing that became clear through the Financial Crisis is the influence financial institutions have on the governance practices of companies from other sectors. Having a dedicated risk committee, for example, may not be necessary for every company. But banks, most of which have risk managers and risk committees, have set a precedent that is increasingly being taken up by companies from non-financial sectors.

ALRiM: Corporate governance, risk management and compliance are closely associated. What is your view of the relationship between the three disciplines?

M.-J.C.: Corporate governance is at the top, because it is about how the companies are directed and controlled. Corporate governance specifies the role and responsibility of the different bodies, i.e., the shareholders, the board of directors, the management and all stakeholders. Once that decision is made, a company needs to think about compliance, audit and risk management, all of which are parts of corporate governance. Risk management helps a company improve its way of doing business. The risk manager, therefore, should also report to the board of directors. In fact, all the three functions that I mentioned, compliance, audit and risk management, should have direct access to the board of directors and not just to the CEO. But at the same time, all three functions must be integrated with the company's business. Risk committees and audit committees are becoming increasingly important as subcommittees to the board of directors. Not all companies in Luxembourg have been set up in this way, but that situation is changing.

D.K.: The three disciplines are connected insofar as all of them fall under the board's oversight. On a day-to-day, operational level, they are three separate disciplines. Risk management and compliance are often separated, but both are under the oversight of the board.

ALRiM: What do you think are the most difficult challenges to increasing gender diversity in corporate governance bodies?

M.-J.C.: On the level of the EU, there has been a lot of discussion about quotas. Although I find these discussions intriguing, personally I am not in favour of quotas. The real question is the number of qualified women in the workplace and their progression in the responsibility grid of a company. I think this situation has improved dramatically in Luxembourg, particularly in the legal field and among the Big Four. It is important, however, that women are not only active on boards, first of all in management as well. In this context, we also need to consider the balance between professional and private lives. Hiring more women only makes sense, if a realistic balance between work and family can be achieved. Without this equilibrium, women will find it difficult to develop their careers. But this equilibrium is also important for men who care for their families.

"Risk management will certainly become increasingly important, but in a more focused way. In this context, governance risk will not be limited to boards alone. Shareholders, managers and other stakeholders will also have an important role to play in managing risk."

Dan Konigsburg

D.K.: Deloitte recognizes the benefits of increasing gender diversity in our boardrooms. In the U.S., approximately 17% of all board members are women. While this percentage is lower than Germany, it is considerably higher than Japan or Korea, for example. In many cases, boards prefer to have directors with experience as a CEO, as opposed to CFOs, COOs or directors from other backgrounds. The assumption appears to be that CEOs are better at synthesizing and analysing problems than people with other backgrounds. Of course, not many women are CEOs, so it is something of a self-perpetuating situation. I think the real issue is seeking diversity in general, whether it be gender diversity, ethnic diversity or professional diversity. Quotas are unlikely to solve the problem.

ALRiM: How do you see the future of corporate governance? Do we need to rethink the concept of a corporate entity? In your opinion, what role should risk management play in this development?

M.-J.C.: I do not think that the idea of a company needs to be redefined. Most companies are organised according to business lines, not necessarily legal considerations. So it is perhaps more important to focus on how we can best adapt companies to their business objectives. In Luxembourg, a high percentage of companies, particularly in the financial sector, are highly dependent on their head offices and we really need to think about the role of the board in this context. I think that they need to become more independent. ILA plans to look at this situation through a survey that we will conduct for our 10th anniversary next year. Directors in general must be independent, so they can perform their duties for a company effectively. Transparency is a key concept in this context and it is becoming increasingly important. But finding the ideal balance between transparency and privacy will be a major challenge for the future.

D.K.: Corporate governance is becoming more standardised between countries. One trend that is appearing more often is shareholder activism. In the future, we are likely to see more active shareholders, who will focus on fewer companies, but with greater intensity. Risk management will certainly become increasingly important, but in a more focused way. In this context, governance risk will not be limited to boards alone. Shareholders, managers and other stakeholders will also have an important role to play in managing risk. The big question will be systemic governance risks, i.e., risks that threaten a company, its industry and the market as a whole from outside. While banks trade in risk and therefore must develop the skills to deal with it, other types of organisations are subject to risks that are imposed on them from outside, but they nonetheless must deal with them.

Although corporate governance is likely to become more homogenous, we still need to have diversity and multiplicity to avoid the systemic risk that we witnessed in 2008 - 2009.

ALRiM: Thank you for sharing your views with us!

Article

Product Governance: How to Oversee the Design, Management and Distribution of Products that Fit the Consumer

Ravi Beegun,
Partner, KPMG, Luxembourg, and Member of the ALRiM Board

In the wake of the financial crisis, the G20 identified consumer protection as a key focus area for reform. These global concerns for consumer protection made their way onto the European regulatory agenda and one of the results was an EU-wide directive – MiFID 2 – voted in this January. The legislation aims to address, amongst others, a perceived asymmetry of information between the investor, who may lack sufficient knowledge around the product, associated characteristics and risks, and the manufacturer, who has relevant and full knowledge, which is not necessarily available to the investor.

Although MiFID II is somewhat intrusive for the industry, it aims to ensure that banks are asking the right questions about products and how they fit consumer profiles and needs. To do this, the directive covers everything from product design to sales organisation, point of sale advice, order execution and even after sales services. In this way, the entire process form start to finish is built around the consumer.

Product governance is no small part of protecting consumers under MiFID II: well-defined and sustained actions and rules underpin the whole process around product design, product management and distribution. In terms of best practice, there is already much to be praised in the way that some industry players go about their governance and oversight. Regulators have put forward some of the best practice examples for structured products, and these principles are also relevant for a wider range of financial products. The following diagram captures some of the key features of a good product governance and oversight process.

Product Governance Arrangements

- Document product governance arrangements
- Allocate sufficient time to perform governance duties and ensure dashboards show relevant information to enhance monitoring key indicators
- Define interactions and flows between manufacturer and distributors (including for investor complaints)

Product Design

- Check that products match the target market's financial needs, investment objectives, knowledge and experience
- Benchmark intra-group transactions with third-party solutions
- Carry out due diligence on counterparties involved
- Check appropriate information is made available to distributors

Product Testing

- Back testing and simulations of future performance scenarios, to check whether aligned to investment objectives of target market
- Independent testing, stress testing, and assessment of external risks
- Communicate with distributors on product testing methodologies and results

Target market

- Conduct research to better understand investor needs, objectives and ability to understand the product
- Check alignment with the ways in which the product is advertised and sold
- Provide information to investor on results of scenario analysis and if counterparty fails

Distribution strategy

- Policies and procedures at manufacturers, covering their distributor strategy, selections and relationships
- Policies and procedures at distributors, covering product training, challenging the manufacturer in case of lack of clarity and refusing to sell products which are not sufficiently understood

Transparency

- Product manufacturers to make the product value (at date of issuance) available to investors
- Disclose all charges and fees to the investor

Secondary market and redemption

- Distributor to disclose trading conditions, pricing methods and possible transaction costs for secondary market, if it exists
- Manufacturers/Distributors to provide information on costs associated with redemption of product

Review process

- Monitor feedback on a product throughout its lifecycle and make appropriate changes when misalignment with initial objectives are detected

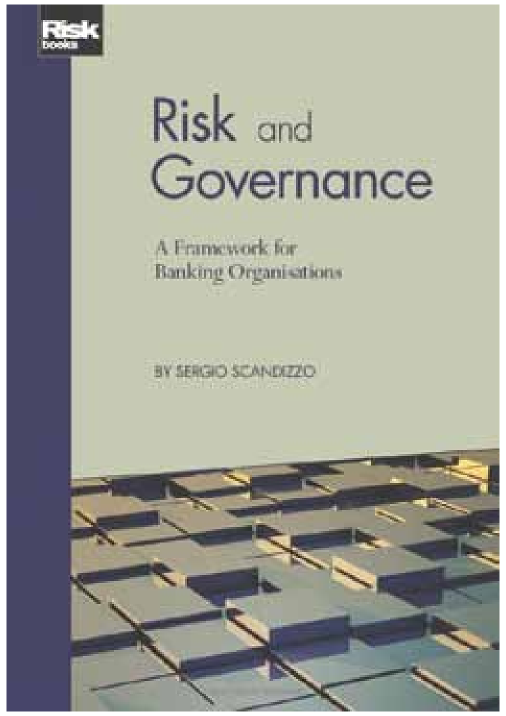
The next steps for governance bodies involved in the product lifecycle value chain are to evaluate how their existing governance arrangements cover some of these good practices and to what extent certain changes may be needed to provide a better fit with the investor agenda. This will go a long way to manage risks, such as litigation risk linked to mis-selling practices and reputation risk linked to regulatory product bans.

Additional reading

- ESMA: *Structured Retail Products - Good practices for product governance arrangements*, 27 March 2014.
- FSA: *Retail Product Development and Governance - Structured Product Review*, March 2012.
- *Joint Position of the European Supervisory Authorities on Manufacturers' Product Oversight & Governance Processes*, 28 November 2013.

Book review

Risk and Governance: A Framework for Banking Organisations



By Sergio Scandizzo.
Published by Risk Books, a Division of Incisive Media Investments Ltd., 2013.

Sergio Scandizzo is well known in Luxembourg not only as a risk manager at the European Investment Bank, but also as an expert in operational risk management. Mr Scandizzo's book *The Operational Risk Manager's Guide* is in its second edition and it is considered a classic work in the area of operational risk management.

The most recent book from Mr Scandizzo is *Risk and Governance*, which is quite different from the other books that he has published. It covers a wide range of topics in corporate governance and risk management that extends from the nature of corporate governance in banking to managing reputational risk and executive compensation. The book is well researched and contains an extensive bibliography, as well as innumerable references to a variety of published sources. It is therefore a very useful tool for finding secondary sources on different areas of risk management and governance.

Unlike many books on risk management that tend to intimidate readers with lengthy mathematical formulas and complex calculations, Scandizzo's *Risk and Governance* is clear, well written and easily understandable for anyone interested in risk management. The book achieves a good balance between theory and practice by providing numerous examples and many useful tools that can be applied in different areas of risk management.

The three sections into which *Risk and Governance* is divided, "Corporate Governance in Banking", "Modern Risk Management" and "Current Practices in Banks", illustrate the book's focus on how corporate governance impacts risk management in banking. Particularly important in this regard is the book's practical approach in aligning bank operations with the decision-making of a board of directors.

Theme for the next issue:
The Changing Role of Risk Management in Investment Funds