

Taming the beast:

Regulation is a double-edged sword – at once a help and hindrance to financial services firms. But, says Tony Harb, understanding risk management can help tame the regulatory beast

In the past, financial services organisations have withstood depressions, recessions, wars, converging markets, consolidations, increased competition, globalisation and new technology, so what's the big deal about the unprecedented level of regulation?

For one thing, the level of regulatory change is not the major issue facing financial services organisations, but rather, it is how organisations respond to these changes at all levels of the organisation that will not only determine the success or failure of risk management initiatives, but the organisation as a whole.

Let's take a step back. Like every other commercial business, financial services organisations exist to provide a service and ultimately return a profit to their owners. To achieve this, a series of activities are undertaken by the organisations. These activities will vary in size, complexity and interdependence. The fact that these activities exist, and are integral to the organisation, gives rise to risk.

All organisations, regardless of size, structure and industry face a range of risks. Some risks may be trivial; others are real and likely to occur. Some risks may have minimal impact on the organisation; other risks may have a catastrophic financial impact.

To manage these risks, organisations typically introduce a range of 'internal' controls that may include segregation of duties, secondary checks and reconciliations.

Although these internal controls are designed to help reduce risk, often, they may become ineffective due to changes in staff, procedure, structure or technology. And when internal controls fail, it's anybody's guess what the full impact could be, hence spectacular failures arise.

Enter regulation, a form of 'external' control that attempts to prescribe minimum control and compliance requirements. When regulatory bodies cannot rely on organisations to develop their own internal control framework, they introduce more regulation, legislation, standards and guidelines.

But regulation can be a double-edged sword. On one hand, additional regulation may improve an organisation's service, protect stakeholders and assist in long-term sustainability of the financial services industry. On the other hand, it introduces additional cost, additional complexity to business and increases the risk of non-compliance to regulatory requirements. This is when risk management can be utilised to help organisations achieve the right balance

The concept of risk management has been around

for centuries. However, every now and then, risk management makes headlines, especially after a large and spectacular failure. Remember AWA and Tri-continental in the early 1990s. Remember Barings Bank and Sumitomo Corp in the mid 1990s?

Since the collapse of HIH Insurance in 2001, and fuelled by several large scale international corporate collapses and accounting irregularities, the Australian financial services sector has experienced considerable corporate governance and legislative reforms from both local and international regulators. Some financial organisations have been affected by up to six major regulatory reforms in less than two years.

The wave of reforms include Australian Prudential Regulatory Authority (APRA) standards and guidelines, the Financial Services Reform Act, the Credit Act, the Sarbanes-Oxley Act, Basel II and the Corporate Law and Economic Reform Program (CLERP) These are only some of the reforms financial services organisations have had to deal with on top of the 'business as usual' regulatory requirements of the Australian Securities and Investments Commission (ASIC), the Australian Competition and Consumer Commission (ACCC), and a myriad of other legislation.

How to deal with regulation and enhance risk management processes

1. Understand the changes

The first step in managing regulatory change is to understand the changes themselves. Understand the objectives of regulatory change and the rationale for the changes.

Grappling with the detailed requirements of each of these regulations is a major hurdle. Seek the assistance of experts where possible. It is interesting to note that National Australia Bank and its auditor KPMG are the first large companies in the world to

be investigated under 2002 US audit independence regulations. How can one of Australia's largest banks and one of world's largest accounting firms be under investigation by a US regulatory authority?

2. Evaluate impact on organisation

The next step is to evaluate the impact of the regulatory changes on the organisation. Regulatory changes have a significant impact on organisational strategy. After the 2002 introduction of APRA Stage 1 reforms, a number of insurers exited the market due to capital requirements.

Yet, many organisations still underestimate the impact of regulation on their business and often see regulation adding little value. The NAB debacle has demonstrated that while complying to regulation may not directly increase shareholder value, not complying will almost certainly diminish shareholder value.

The more complex and diverse an organisation, the greater the risk management effort required. For example, financial services organisations providing banking, life, superannuation and general insurance services will have more risk and compliance requirements across all these lines than a niche insurer.

regulation



Potentially, diverse organisations may get so caught up in the compliance web that they may not be able to respond to business opportunities as quickly as their smaller, niche competitors.

3. Develop a formal strategy

Once the impact is analysed, organisations need to develop an 'appropriate' risk management strategy. An appropriate strategy is important because it defines what and how the organisation will manage risk.

A good strategy should clearly document the risk management framework and objectives of risk management in the organisation. It will also define clear responsibilities and time frames.

One issue facing organisations is which risk management framework should we adopt, COSO or AUSNZS:4360? Remember, none of these are a perfect fit to your organisation. They are only guides, use them to guide you through the risk management strategy process.

4. Implement the strategy

The next challenge is to integrate risk management principles and processes into the business. Having a risk

management strategy is great, but taking it off the mantelpiece and involving people in the organisation is critical. Remember, even, HIH had a corporate governance policy, it just wasn't implemented very well.

Implementing the risk management strategy can be resource intensive. Initiatives like process mapping, risk analysis, control evaluation and testing will require good quality and experienced resources. These resources may not be readily available and therefore internal training may be required.

Implementation will take time, consume resources and cost money. A realistic budget is also important to ensure there are sufficient funds to implement the strategy correctly.

Increasing cost will eat into an organisation's profit margin and prompt senior management to question the risk management strategy.

Recent developments in risk management software technology provide organisations with better tools to help manage the risk management process. A superior risk management system will help reduce implementation costs.

5. Continue to monitor

Regulations change, so a key component of risk management is to stay up to date with developments and continue to monitor the changes and their potential impact on your organisation.

State of play: Regulation now and in the future

Starting in July 2002, APRA introduced its first round of insurance reforms by way of technical standards covering minimum capital requirements and governance standards covering risk management. In addition, a new statistical reporting regime known as D2A (Direct to APRA) was introduced.

The Australian Stock Exchange principles fol-

lowed in March 2003 with its 10 "principles" of good corporate governance. These principles apply only to listed companies and are officially non-binding. They attempt to tighten up boardroom and management procedures, including the disclosure of corporate pay deals. In Canada, the Toronto Stock Exchange has also introduced similar corporate governance guidelines.

In November 2003, APRA announced its proposed Stage II reforms in direct response to the HIH Royal Commission. These reforms aim to further tighten capital requirements, governance and disclosure requirements. They will also extend to activities such as outsourcing and business continuity management.

Although the Financial Services Reform Act (FSRA) came into effect on 11 March 2002, there was a two-year transition period and so compliance was only mandatory from 11 March 2004.

It essentially requires businesses that provide financial services to be licensed under ASIC and undertake various activities to ensure a more pleasant consumer experience.

CLERP has been released and deals with corporate accountability, continuous disclosure and protection of shareholders rights. It aims to strengthen supervision and compliance by requiring two officers to certify the accuracy of the financial statements to the board of directors

Recently a 31-nation Financial Action Task Force (FATF) handed down 40 recommendations on money laundering in Berlin. Banks and other financial institutions would be required not only to verify the identity of their customers but to take reasonable measures to identify beneficial owners of accounts.

In the past, the Australian Federal Government has strongly backed the FATF rules and will revise recommendations to see if local legislation and regulations need to be overhauled.

Internationally, in 2002, the US Government passed the Sarbanes-Oxley regulations to strengthen corporate disclosures and combat fraud in the after several US accounting scandals including Enron and WorldCom.

Under section 404 of the Sarbanes-Oxley Act, companies registered with the US Securities and Exchange Commission (there are about 30 in Australia) will be required to assess and report on the effectiveness of internal controls over financial reporting for financial years ending after September 2003. Although many US companies (and their Australian subsidiary) need not comply to the Sarbanes-Oxley Act, countless organisation are still adopting the act to keep up with their SEC registered competitors as it is seen as good business practice.

By 2007, implementation of the Basel II Accord has been estimated to have cost the financial services industry more than \$4 billion worldwide and consume more time and effort than was spent dealing with the Y2K issue.

Although the Basel II requirements have been widely anticipated by the conventional banking industry, their effects on the operations and risk management strategies of non-banking financial services are not as clear.

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