

Contents

About the Author	xiii
1 Introduction	1
1.1 Introduction	2
1.2 Boards	3
1.3 Why Now?	5
1.3.1 Governance Expectations	5
1.3.2 Technical Changes	6
1.4 Rest of the Book	7
Further Reading	9
PART I RISK OVERSIGHT	11
2 Risk – An Overview	15
2.1 Terminology	16
2.1.1 Definition of Risk	16
2.1.2 Risk	17
2.1.3 Uncertainty	18
2.1.4 Precautionary Principle	21
2.2 Role of Banks and Risk	22
2.2.1 In the Beginning	23
2.2.2 Where are We Now?	24
2.3 Sources of Risk and Uncertainty	25
2.3.1 External Sources of Risk and Uncertainty	25
2.3.2 Internal Sources of Risk and Uncertainty	27
2.3.3 Systemic Risk	27

2.4	Capital	28
2.4.1	Confidence Interval	29
2.4.2	Book Capital	32
2.4.3	Economic Capital	32
2.4.4	Regulatory Capital	33
2.5	Issues to Consider	34
	Further Reading	35
3	Risk Oversight	37
3.1	Introduction	38
3.2	Perspective	39
3.2.1	Bottom	40
3.2.2	Top	41
3.2.3	Middle	42
3.3	Models	43
3.4	Risk Framework	45
3.4.1	Three Lines of Defence	45
3.4.2	Risk Owners	48
3.4.3	Corporate Risk Management Functions	49
3.4.4	Chief Risk Officer	51
3.4.5	Policies, Standards and Procedures	53
3.5	Biases	54
3.6	Issues to Consider	56
	Further Reading	57
4	Risk Management	59
4.1	Introduction	60
4.1.1	Definition of Risk Management	60
4.2	Terminology and Components	61
4.2.1	Cause and Effect	61
4.2.2	Exposure and Event	63
4.2.3	Effects and Consequences	64
4.3	Risk Management Cycle	65
4.3.1	Identify the Risk	68
4.3.2	Assess the Risk	69
4.3.3	Evaluate the Risk	70
4.3.4	Manage the Risk	70
4.3.5	Monitor and Review the Risk	72
4.3.6	Escalation and Reporting	72
4.4	Issues to Consider	73
	Further Reading	74

5 Risk Appetite	75
5.1 Introduction	76
5.2 Terminology and Concept	77
5.3 Stakeholders	79
5.4 Expressions of Risk Appetite	82
5.4.1 Board-level Risk Appetite Considerations	82
5.4.2 Cascading Risk Appetite Down the Firm	83
5.4.3 Dynamic Aspects of Risk Appetite	86
5.5 Framework	87
5.6 Risk Reporting	91
5.7 Issues to Consider	94
Further Reading	95
6 Risk Culture	97
6.1 Introduction	98
6.2 Terminology	100
6.2.1 Definitions and Descriptions of Risk Culture	100
6.2.2 Expressions of Risk Culture	102
6.2.3 The Individual	104
6.2.4 Groups and Teams	106
6.3 Assessing and Influencing Risk Culture	108
6.3.1 Assessing Risk Culture	109
6.3.2 Influencing Risk Culture	112
6.4 Monitoring Risk Culture	117
6.5 Issues to Consider	118
Further Reading	119
PART II SPECIFIC RISKS	121
7 Credit Risk	125
7.1 Introduction	126
7.2 Definition of Credit Risk	127
7.3 Framework	130
7.4 Risk Appetite Metrics	134
7.4.1 Simplest Metrics – Credit Exposure	135
7.4.2 Intermediate Metrics – Probability of Default	137
7.4.3 Complex Metrics – Loss Given Default	142
7.4.4 Economic Capital	145
7.5 Credit Risk Management	149
7.5.1 When Things are Running Smoothly	149

7.5.2	When Things are Not Running Smoothly	150
7.5.3	Reducing Credit Risk	152
7.6	Issues to Consider	158
	Further Reading	158
8	Market Risk	159
8.1	Introduction	160
8.2	Definition of Market Risk	161
8.3	Market Risk Framework	164
8.3.1	Roles in the Framework	167
8.3.2	Risk Appetite and Economic Capital	169
8.4	Market Risk Estimation	171
8.4.1	Simplest Metrics – Exposures and Stop-Loss	172
8.4.2	Intermediate Metrics – Risk Factors	173
8.4.3	Complex Metrics – Portfolio Simulation	177
8.4.4	Economic Capital	180
8.5	Market Risk Management	183
8.5.1	Performance Measurement	184
8.5.2	Back Testing	184
8.5.3	Market Liquidity of Positions	185
8.5.4	Discontinuities	186
8.5.5	Stress Testing	187
8.6	Issues to Consider	188
	Further Reading	188
9	Operational Risk	191
9.1	Introduction	192
9.2	Definition of Operational Risk	193
9.3	Operational Risk Framework	196
9.4	Operational Risk Estimation	202
9.4.1	Indicators	202
9.4.2	Models	204
9.5	Operational Risk Management	208
9.5.1	Operational Risk Management Objectives	208
9.5.2	Sources of Risk Information	209
9.5.3	Operational Risk Focal Points	211
9.5.4	Risk Transfer	212
9.6	Issues to Consider	213
	Further Reading	214

10 Liquidity Risk	215
10.1 Introduction	216
10.2 Definition of Liquidity Risk	217
10.3 Liquidity Risk Framework	220
10.3.1 Roles in Funding Liquidity Risk Management	221
10.3.2 Cost of Funding	222
10.4 Liquidity Risk Measurement	224
10.4.1 Short Term	225
10.4.2 Very Short Term	227
10.4.3 Long Term	228
10.5 Liquidity Risk Management	229
10.5.1 Overview	230
10.5.2 Stress Testing	232
10.6 Issues to Consider	233
Further Reading	234
11 Other Risks	235
11.1 Introduction	236
11.2 Reputational Risk	237
11.3 Strategic Risk	239
11.4 Business Risk	241
11.5 Other Market Risks	242
11.6 Model Risk	244
11.7 Supplier Risk	247
11.8 Resources	249
11.9 Issues to Consider	251
Further Reading	252
12 Risk Interactions	253
12.1 Introduction	254
12.2 Risks as Frequency and Severity Drivers	256
12.3 Risk Interactions	259
12.3.1 Credit Risk with a Market Risk Severity Driver	259
12.3.2 Credit Risk with an Operational Risk Severity Driver	262
12.3.3 Market Risk or Operational Risk as the Severity Driver	263
12.3.4 Funding Liquidity Risk with an Operational Risk Severity Driver	264

12.4 Implications for Risk Management and Measurement	266
12.5 Issues to Consider	269
Further Reading	269
PART III REGULATORY ENVIRONMENT	271
13 Regulatory Environment	275
13.1 Introduction	276
13.2 Structure of Prudential Regulatory Process	277
13.2.1 Mapping the Regulators	279
13.2.2 Impact on Firms	281
13.3 Scope of Prudential Regulation	286
13.3.1 Pillar 1 – Minimum Capital Requirements	288
13.3.2 Pillar 2 – Supervisory Review Process	295
13.3.3 Pillar 3 – Market Discipline	297
13.4 Regulatory Influence	299
Further Reading	303
Disclaimer Regarding Excerpts from S&P Materials	305
Index	307