Assessment of the Internal Governance as an Element of the Supervisory Review and Evaluation Process (SREP)

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Abstract

In recent years, the internal governance issues in the banking sector have received increased attention on the international level. One of the global financial crisis causes was banks' weak and superficial internal governance practices. Before the financial crisis, banks have not effectively implemented the internal control mechanisms and risk management, because the goal of profit maximization prevailed and conditioned the banks managers to take the decisions with a high degree of risk. The European Banking Authority (EBA) is constantly concerned with issuing the best policies for an efficient banking supervision in the European countries. In this context, EBA included the internal governance assessment as a component of the Supervisory Review and Evaluation Process (SREP). The difference between the previous researches on the internal governance topic and the present article is the fact that it analyzes the peculiarities of the internal governance assessment during the SREP process, performed by the supervisory authority. The supervisory authority task is to assess whether or not a bank's internal governance arrangements are adequate for and correspond to the institution's risk profile, business model, size and complexity. The score assigned following the internal governance assessment expresses the supervisory authority view on the adequacy of the institution's internal governance arrangements and institution wide controls.

Keywords: banks, banking supervision, internal governance, internal control, risk management

JEL Code: G21; G34

1. Introduction

Getting profit is the main objective of the management of a bank. The tendency of profit maximization can often make the banks to ignore the risk level in order to achieve a bigger profit. If a bank's management is a qualified one, it will be aware that the registration of high performance does not mean stability of the bank and the safety of the decisions taken.

One of the main tasks of banking supervision is to ensure the sustainability and viability of credit institutions. In the framework of the SREP evaluation, the supervisory determines the quality

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of the strategies, processes and mechanisms implemented by banks and the sufficiency of their own funds and liquidity to ensure the coverage of all risks.

The Guidelines on common procedures and methodologies for the supervisory review and evaluation process, published by the European Banking Authority in December 2014, cover in details all aspects of the SREP process. The overall result of SREP gives to the bank an evaluation score, which represents the supervisory assessment of the institution's risk profile and viability.

The term internal governance refers to the internal organization of a bank's activity and the way it develops and manages its business and risks.

In the context of the SREP Guidelines, the internal governance includes the general framework of the administration of a bank's activity, organization and functioning of the management body, organization of the internal control functions of the bank, organization of the risk management framework, etc.

Although different researchers assessed the internal governance topic, the present article addresses a different approach of this term, by its analysis within the SREP framework. The internal governance analysis within the SREP framework differs from the traditional analysis of the internal governance, as the supervisory review and evaluation process requires a very deep assessment of this element, as all the findings should be relevant in order to justify the score given to the institution.

The article is organized in four main parts that focus on the internal governance assessment during the SREP process:

- The first part is dedicated to a succinct literature review of internal/corporate governance, identifying, among numerous definitions, the key-features of this term.
- The second part focuses on the assessment of the banking management framework as a part of the internal governance, including aspects concerned with organizational structure and organization and responsibilities of the management body.
- The third part reveals the assessment of the internal control functions, such as internal audit, risk management and compliance.
- The fourth part emphasizes the assessment of the quantitative aspects of the internal governance, including the risk management framework, risk appetite and the Internal Capital Adequacy Assessment Process (ICAAP).

2. Literature review

In the extremely vast economic literature devoted to this topic, analysis of various aspects of internal/corporate governance can be encountered, thus showing the complexity of this term.

Concerning the definitions of the internal/corporate governance, there is not a single definition of this term rather it might be viewed from different angles. Among the first definitions, the corporate governance was defined as ,,the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer and Vishny, 1997).

Organization for Economic Co-operation and Development (OECD) in 1999 defined corporate governance as ,,the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs".

Another researcher defined the internal governance as ,,the processes, customs, policies, laws and institutions that direct the organizations and corporations in the way they act, administer and control their operations" (Khan, 2011).

According to the EBA Final Report on Guidelines on internal governance (EBA/GL/2017/11), internal governance includes all standards and principles concerned with setting an institution's objectives, strategies and risk management framework. It also focuses on how the business is organized; how responsibilities and authority are defined and clearly allocated; how reporting lines are set up and what information they convey; and how the internal control framework is organized and implemented, including accounting procedures and remuneration policies.

The corporate governance was also examined from the point of view of 2 core aspects: internal and external. Internal aspects include ownership structure, the board of directors and committees, internal control, risk management, transparency and financial reporting. External aspects can either be market-oriented, or can take the form of credit ranking, and/or social requirements (Naciri, 2009).

There can be emphasized 3 pillars of corporate governance: transparency (allowing to be observable to outsiders the processes and transactions of a company), accountability (building integrity in a company), and security (a company is expected to make their processes transparent and their people accountable while keeping their enterprise data secure from unauthorized access) (Roman, 2019).

Regarding the internal governance in the banking sector, the KPMG audit company (2018) in the article ,,Internal governance: Addressing weaknesses" mentioned that the internal governance remains a key area of focus for European banking supervisors, playing a fundamental role in maintaining the stability and reliability of individual institutions and the entire banking system.

Supervisory authorities must require institutions to have an adequate risk management processes and internal control mechanisms, including sound reporting and accounting procedures in order to identify, measure, monitor and control all the transactions.

3. Banking management framework

The assessment of the inherent risks of the banking management framework has more a qualitative nature than quantitative nature. When assessing this type of risk will be initially collected information and documents about the management body of the bank (executive body, council and its specialized committees), paying closer attention on the bank's organizational structure, the powers, responsibilities, composition and functioning of the management body, the degree of adequacy of the bank’s administrators (composition, qualification, experience). As well, will be assessed if the bank has a clear organizational structure, with well-defined, transparent and correct lines of responsibility and if the persons that hold key functions in the bank are properly identified and evaluated.

In order to establish properly the score for the internal governance and institution-wide control arrangements, the supervisor should answer the following key-question: Are the internal governance and institution-wide control arrangements adequate for the identification, management, monitoring, reporting and reducing the risks, given the nature, the magnitude and the complexity of the bank?

3.1. The organizational structure

It is important to have a general understanding of the way is organized the bank’s activity. In this regard, will be analyzed the organizational structure of the bank, including if there is a clear delimitation between the business lines, business units, staff with key-functions and the structure of the reporting units. The supervisor will assess if the organizational structure is clear, with well-defined, transparent and correct lines of responsibility. A comprehensive understanding of the way is organized and function the bank’s activities is essential for the assessment of the adequacy of the internal governance processes and the internal control mechanisms, as well as their adequacy depending on the structure, business and risks assumed by the bank.

In order to analyze the organizational structure of the bank, will be assessed if the bank has a well-defined organizational structure and if at the establishment of the banking activity management framework is taken into account the nature, the magnitude and the complexity of the inherent business model risks. For the same purpose, will be evaluated if the bank’s staff is properly selected and is performing its activities according to its duties. Also, will be analyzed the ownership structure of the bank, its structural changes, the identity of the direct and indirect shareholders’, including the beneficiary owners.

3.2. Organization and responsibilities of the management body

The council is the management body of the bank, which has supervisory duties of bank performance, approval and monitoring of implementation of strategic objectives, governance framework and corporate culture by the executive body, and is responsible for overall bank activity.

When assessing the adequacy of the council members will be assessed if the members:

1) are aware of the structure of the management body and distribution of the duties and responsibilities between the executive body, the council and its specialized committees

2) ensure the compliance with the experience and knowledge on individual and collective level

3) perform their tasks with honesty, objectivity and loyalty, dedicate enough time and caution in their performance and in strict compliance with the legal framework

4) actively participate in the activity of the bank and are able to take decisions and make their own sound, objective and independent judgments

5) define and understand the organizational structure of the bank, the ICAAP and the general framework for crisis simulations.

The bank should have 4 specialized council committees: Audit Committee, Risk Management Committee, Appointment Committee and Remuneration Committee.

When assessing the adequacy of the specialized committees' members, will be analyzed the following aspects:

1) In case of assessing the Audit Committee: the independency of the head of Audit Committee and the performance of the Committee duties according to the provisions of the Regulation on banking activity management framework.

2) In case of assessing the Risk Management Committee: the given support to the council regarding the current and future risk appetite and risk strategy of the bank, regarding the establishment of the nature, volume, format and frequency of the information concerning the risks and monitoring the appliance of this strategy by the executive body.

3) In case of assessing the Appointment Committee: the relevant experience concerning the process of selection and evaluation of the adequacy of the candidates for the positions in the management body of the bank and key-functions.

4) In case of assessing the Remuneration Committee: the realization of duties with competence and independence, the relevant experience regarding the remuneration policies and practices, risk management and/or audit/controlling activities, especially concerning the mechanism for alignment the remuneration structure at the bank's risk and capital profile.

The executive body is in charge of managing the current business of the bank, reports to the council and shall ensure proper implementation of the bank's management framework, develop and approve secondary bylaws, where appropriate.

When analyzing the efficiency of the management of the current banking activity, will be assessed the professional standards, the quality of the collective decision making process and the uniform distribution of the duties, as well as the extent to which the members of the executive body are aware of the newest activities of the bank. These aspects will be assessed by the analysis of the quality of the executive body reports and minutes of the meetings, including the examination of their decisions.

At this stage will be assessed if the executive body of the bank maintains efficient policies for the identification, evaluation, management and mitigation or prevention the current and potential conflicts between the bank's interests and the private interests of the staff and management body.

Also, will be assessed if the members of the executive body have the professional reputation and necessary knowledge and experience in the field of activities allowed to the banks, as well as sufficient skills for performing the duties in the bank.

The supervisor will assess if the executive body takes decisions based on sound information, which does not contradict the bank's strategies, encourages sound and prudent management and does not threaten the bank's financial soundness and the legal interests of the interested parts. As well, will be verified if the decision-making process of the executive body cannot be dominated by one person or a group of persons, and the decisions are taken in an objective and impartial way and follow the bank's interests and not the personal one.

4. Internal control mechanisms

Internal control functions shall include a risk management function, a compliance function and an internal audit function. The risk management and compliance function shall be verified by the internal audit function.

4.1. Internal audit function

The organizational structure of the bank should be organized so as to make sure that the internal audit function is not directly involved in the operational organization of the bank and that the auditors are independent and do not perform operational tasks that enter in the sphere of activities that are under their control and/or monitoring. However, the audit function should actively cooperate with other functions, relevant committees and bank's subdivisions, in the extent to which this activity is according to its tasks and level of independency.

The supervisor will assess if the audit function performs its activity in accordance with the internal regulation on the internal audit, approved by the bank's council that includes information about the way of organization, rights and responsibilities, cooperation with other bank's subdivisions.

As well, will be assess the nature and the scope of the audit, in order to ensure that it covers efficiently and extensively the bank's activities and risks, including the outsourced activities.

The supervisor will assess if the audit function has sufficient resources, including an adequate number of qualified staff, IT systems that allow the audit performance in an efficient and adequate way, according to the audit program planned for the reporting year. Will be assessed if the internal auditors benefit from continuous training and professional development in order to deal with the increasing technical complexity of the banks' activities and the increasing tasks diversity that should be performed as a result of introduction of the new products and processes in banks and other evolutions within the financial sector.

In order to verify if the audit function covers all the activities and risks to which the bank is exposed, will be assessed if the bank elaborates and implements at least annually the internal audit program and if it is approved by the bank's council. The frequency of the audit of activities and risks (audit cycle) should be defined depending on the impact of the audited activity on the risk profile of the bank on the importance of this activity in the income obtaining.

The supervisor will assess if the internal audit function ensures the current reporting of the significant findings to the bank's council and the audit committee and informs the executive body. Also, will be verified if the internal audit reports quarterly to the bank's council and the audit committee about the results of the internal audit activity. The report should contain information about the achievement of the objectives/responsibilities, the sufficiency of the staff engaged in the internal audit process, the identified shortcomings, corrective measures and the results of monitoring the fulfillment of internal audit recommendations.

4.2. Risk management function

The bank shall have the risk management function under the direct supervision and responsibility of the council of the bank. It has the task to identify, measure, evaluate and monitor the risks to which the bank is exposed, to determine the capital and liquidity needs in the context of risks to which the bank is exposed, to monitor and assess the consequences of accepting certain risks, etc.

The supervisor should assess if the risk management function realizes at least the following:

1) identifies the risks to which the bank is exposed, measures, evaluates and monitors these risks and the real exposure of the bank to that risks

2) determines the capital and liquidity position in the context of risks to which the bank is exposed

3) monitors and assesses the consequences of accepting certain risks, mitigating their impact and matching the level of risk to the level of risk tolerance

4) reports to the bank's management body and issues relevant recommendations.

The supervisor should determine if the bank has a member in the executive body with general responsibility for the risk management function (Chief Risk Officer (CRO)). The CRO has the main responsibility of the supervision of the development and implementation of the risk management function within the bank. CRO is responsible for giving support the bank's council in its engagement to supervise the elaboration of the risk appetite and of the report on the risk appetite and for transposing of the risk appetite in a structure of risk limits. The CRO together with the executive body should actively involve in the performance monitoring in relation to risk taking and adherence to risk limits.

An adequate risk management requires the bank to dispose reliable risk management instruments based on reliable data sources. The risk supervision should be an integral part of the bank's culture and values. The risk dimension should be taken into account in a clear way in all the processes and development strategies of the bank.

When evaluating the risk management function, the supervisor will take into account that a sound risk culture set up at the bank level represents one of the key elements of efficient risk management. Implementation of the adequate standards for a professional and responsible behavior in the whole bank should contribute to the reduction of the risk to which the bank is exposed.

The supervisor will assess if the risk management function permanently cooperates with the council and its specialized committees, mainly with the Risk Management Committee, for taking adequate decisions concerning the risk exposure of the bank. The risk management function reports that include identification of the new risks or of the existing risks that are not administrated, should lead at an adequate review of the internal controls and of the measures of diminishing of those risks.

4.3. Compliance function

The compliance function is an independent function within the bank, under the direct supervision and responsibility of the council of the bank that has the task to ensure the compliance of the bank's activity with the legal framework and internal regulations and to provide information regarding the evolutions in this field.

The supervisor will assess if the compliance function carries out its activity based on a program that includes, at least:

1) implementation and review of specific policies and procedures

2) assessing the compliance risk, testing and informing the bank's staff on the compliance aspects

3) verifying the compliance of the new products and new procedures to the legal framework and its amendments

4) elaboration and appliance of the methodologies of evaluation the compliance risk by using the performance indicators

5) monitoring and testing the compliance based on relevant tests and communication of results according to the reporting lines of the bank and to the internal risk management procedures.

A banking management framework that works according to the bylaws, internal regulations of the bank and the legal framework in an indicator of efficient functioning of the compliance function within the bank.

The supervisor will assess if the compliance function staff:

1) has access to any records, information or documents necessary for fulfillment of the tasks and responsibilities

2) can conduct investigations on the possible violations of the compliance policy and reveals freely the findings to the management body

3) proposes recommendations for the purpose of correction of the identified non-compliance situations.

The supervisor will assess if the composition and the structure of the compliance function are according to the nature, size and the complexity of the activity performed by the bank. In this regard, will be analyzed the organization of the compliance function at the banks with a similar risk profile.

Within the limits of available information sources will be assessed if the compliance function participates at the approval of the new products or at the significant changes brought to the existing products, processes and systems. The role of the compliance function consists in assessing the compliance of the rules of application of new products with the applicable legislation, especially in the process of marketing and communication of the new products and services.

The report of activity of the compliance function should contain information about the activities of the compliance function performed in the reporting period (for example: the result of risk compliance evaluation), the significant changes in the legislation in force, the identified compliance deficiencies and recommendations for their remedial, etc. This report should be well documented and presented at least annually to the management bodies.

5. Risk management framework and risk culture

The analysis of the risk management framework concentrates on 3 key dimensions:

1) Risk Appetite Framework
2) Risk culture
3) ICAAP framework

These dimensions reflect the quality of the existing procedures and offers a support for the management body in the establishment and communication of the risk appetite and internal governance framework of the bank. For the evaluation of the internal governance framework of the bank, the important information sources are information obtained as a result of the dialog between the supervisor and the bank. This communication gives the supervisor a general image of the bank's risk level, because, as a rule, if the banks have a very open communication strategy, this is an indicator of a good risk profile management at the bank level.

5.1. The Risk Appetite Framework (RAF)

The supervisor should assess the bank's risk appetite through the risk appetite management framework and the risk limits, concentrating in the same time on the capacity to evaluate the real risk profile of the bank to the desired one. As well, will be assessed if the bank takes into account and applies RAF in the strategic decisional process at the level of the whole bank.

Implementation of an efficient RAF that will cover the activity of all the bank requires that it contains a combination of polices, processes, controls, systems and procedures at the bank level. At the RAF assessment, the supervisor will take into account these elements and will analyze the level of integration of the RAF in the decision making process and in risk management at the whole bank level.

The supervisor will assess the RAF quality including the discussions with the management body, as a result of assessment of the connection between the bank's business strategy and its risk appetite, as well as following the results of the evaluation of the risk appetite impact on the bank's decisions.

The declaration regarding the risk appetite is a part of the bank's strategy and identifies the risks that can materialize in normal conditions and stressed conditions and establishes clear actions that are going to be taken for the reduction of these risks. It should include quantitative methods of risk quantification that can be easily associated and attributed to different business lines, branches and bank's subdivisions.

5.2. The risk culture

The management body of the bank should develop and promote high ethical and professional standards, taking into account the needs and the specific characteristics of the bank and to ensure the implementation of such standards. The applied standards should have as a goal the reduction of the risks to which the bank is exposed, and the management body is responsible for the supervision of compliance with these standards by the employees. Within the implementation of these standards, the management body must have clear and documented policies that will promote the risk awareness by a risk culture, with the reflection of its expectations, according to which the bank's activities will not exceed the risk appetite and the risk limits established at the bank level.

The supervisor will assess if the bank has implemented a risk culture at the level of each subdivision and not only at the level of specialists in the fields of risk or risk management, compliance and internal audit function.

Within the risk culture, assessment will be also analyzed if the bank's management body allocate sufficient time for the examination of the problems linked with the risk administration. This aspect will be assessed by the analysis of the management body minutes, decisions liked with the risk administration, the approved policies and the level of staff training.

The supervisor should analyze if the bank's risk culture is adequate for the extent, complexity and the nature of its activity, as well as if it is based on reliable and clear values, that take into account the risk appetite of the bank.

5.3. The ICAAP framework

The assessment of the internal capital adequacy (ICAAP) allows the supervisor to determine if the bank's internal capital can cover all the risks to which the bank is or can be exposed, in an appropriate manner to the nature and the level of these risks.

The supervisor will review the ICAAP process and determine its soundness, effectiveness and comprehensiveness, as well as will evaluate how the ICAAP process is integrated into general risk management and strategic management practices, including capital planning. The results of these evaluations will contribute to the calculation of the additional capital requirements.

For an overall understanding and validation of the bank's results related to ICAAP quantifications and their reliability, the results will be compared and reconciled with the quantifications made by the supervisor, and in case of recording differences between results, the supervisor will verify and identify the causes of these deviations.

When assessing ICAAP, the supervisor will take into account the results of internal governance assessment, control functions, administration, as internal capital estimations cannot be considered adequate without adequate governance and control mechanisms.

6. Conclusions

Trust in the reliability of the financial system is very important for its proper functioning. Sound internal governance arrangements are fundamental for a good functioning of the banking institutions individually and the banking sector as a whole. Ensuring an adequate internal governance of the bank involves the correct establishment of the bank's strategic objectives, ensuring an efficient management of the bank’s activity and internal control mechanisms as well as prudent administration of the bank’s activity in accordance with the administrative, legal and prudential requirements and regulations. The internal governance should be appropriate to the nature, scale and complexity of the institution. The main responsibility for internal governance lies with the management body, which is subject to specific suitability requirements.

The areas that banks should prioritize in order to increase the quality of their internal governance are:

- proper functioning of the management body, including members’ sufficient level of commitment and independence and establishment of adequate internal administration practices and procedures;

- developing a strong risk appetite framework, taking into account all the significant risks to which the bank is exposed, including risk limits, tolerances and thresholds;

- developing a solid and effective ICAAP process, to evaluate and maintain an adequate level of capital to cover the risks to which the banks are exposed or likely to be exposed;

- focusing on data quality, high quality data being a pre-requisite for effective control, and the basis of all sound decision making.

In the context of the mentioned above facts, the safety and viability of banks is crucial to their financial stability, and their efficiency is directly proportional to the way their activity is managed. A poor governance of banks can result in the extension of their problems to the level of the banking system, thus violating both the rights of shareholders and of the depositors, being endangered the financial soundness of an economy.

Assessment of the internal governance during the Supervisory Review and Evaluation Process and informing the banks about all the identified shortcomings will improve their internal governance.

Effective internal governance plays a key role in ensuring the continuity and stability of the bank. A permanent and timely assurance of the capital adequacy, liquidity, profitability and asset quality, an efficient management of the banking activity, the compliance with laws and internal policies, represent a guarantee of a successful banking business and creates prerequisites for a sustainable development of banks.

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