Banking Industry Risk Management Survey Report
National Bank of Ethiopia

I. INTRODUCTION

The National Bank of Ethiopia (NBE) plans to move towards risk based supervision of banks. International experience suggests that such a move presupposes enhanced supervisory reliance on work of third parties, including that of banks. For improved reliance on work of third parties, supervisors need to ensure existence of strong risk management practice in supervised banks.

To this end, the NBE conducted, in November 2009, its first bank risk management survey. Nine staffs[1] of the Bank contacted all the 15 banks in the industry with a questionnaire to be completed.

The survey aimed to identify status of risk management practices by banks and to put forward recommendations to address weaknesses.

The rest of this report[2] has three sections. The second section presents 'executive summary', the third 'detailed findings', and the fourth 'conclusion and recommendations'.

---

[1] Ato Gobena Worana, Ato Tsega Mekonnen, Ato Behailu Fekadu, Ato Abdilkadir Muche, Ato Chalchisa Debere, Ato Getnet Adane, Ato Tesfamariam Hailu, Ato Wubshet Fola, and Ato Yitbarek Mezemer

[2] Drafted by Ato Gobena Worana and Ato Tsega Mekonnen; edited by Ato Solomon Desta and approved for circulation by H.E. Ato Getahun Nana

Finally, the NBE would like to thank all the banks who participated in the survey.

II. EXECUTIVE SUMMARY

Results of banking sector risk management survey suggest existence of some positive steps taken so far by banks to strengthen their risk management practices. For instance, bank boards have given fairly adequate attention to risk management, risk management function has qualified staffs, risk management policies and procedures are in place, and business continuity/contingency plans exist for operational and liquidity risks. However, as detailed hereunder, weaknesses dominate banking sector risk management practices and thus indicate some supervisory concerns.

i. Board responsibility

- Full/part of board members in 87% of banks did not sit for training on risk management.
- 60% of banks' boards of directors are not provided with relevant and up-to-date economic, business and market data for informed decision-making.

ii. Structure and resources

- Specific budget allocated to risk management function in 75% of banks is either relatively insignificant (0.14-0.43% of total budget), or unknown.
- In 73% of banks, only part or none of the staffs were trained in risk management.

iii. Strategies, policies and programs

- 60% and 74% of banks have not yet documented risk management strategy and program, respectively.
- 50% or above of banks lack timeframe to periodically review risk management documents.

- Risk management policies of 60% of banks do not define risk limits, & 93% of the rest either rely only on NBE limits for counterparty, or above 3/4th of them did not define limits at all for geography, product, security, sector, etc.

iv. Communication

- Internal communication of risk appetite and findings is low in 60% of banks.

v. Appraisal and reward

- Risk management process, in the vast majority (87%) of banks, is either partly or fully not integrated with HR management and policies.

vi. Benefits and outcomes

- No weakness.

vii. Auditors

- 77% of external auditors and 60% of internal auditors of banks do not independently review effectiveness of banks' risk management functions.

viii. Risk identification and preparedness

- Risk management function of 93% of banks does not capture risks related to procurement and HR.
- 87% of banks do not conduct workshop to identify risks in each activity/product, 60% of them have not created risk register, and 87% of them do not exercise stress testing as a risk management tool.
- 93% of banks do not have continuity/disaster recovery/contingency plan in place for other risks like market, reputation, etc.

ix. Nature of risks facing banks

- Credit, operational and liquidity risks were key bank risks over the last two years, and will continue to be so over the next five years.

Recommendations

To strengthen banks' risk management: i) the NBE should review the existing risk management guidelines and issue them to all banks; ii) banks should be required to produce risk management programs acceptable to the NBE by giving due attention to credit, operational and liquidity risks; and iii) the NBE should design and implement short-term training programs to banks' board members and risk management staffs.

III. DETAILED FINDINGS

Banks were asked selected questions under the following headings:

i. Board responsibility;
ii. Structure and resources;
iii. Strategies, policies and programs;
iv. Communication;
v. Appraisal and reward;
vi. Benefits and outcomes;
vii. Auditors;
viii. Risk identification and preparedness; and
ix. Nature of risks facing banks.

i. Board responsibility

Banks were asked eight questions under this heading. These questions are designed to review whether bank boards are aware of their responsibilities and give adequate focus to risk management.

	"Yes" responses
1. Does your board have formal terms of reference for risk management?	53%
2. Is your board aware of risk management requirements expected from your bank by the NBE?	100%
3. To what extent are board members trained in risk management area?	
Fully	13%
Partly	20%

Not at all	67%
4. Is risk management standing board agenda item?	67%

	"Yes" responses
5. How much time does the board spend on average over the last one year on risk management issues in terms of percentage?	
0-5%	0%
6-10%	8%
11-25%	38%
26-50%	46%
>50%	8%
6. How do you rate degree of risk management on board's agenda?	
Low	7%
Medium	60%
High	33%
7. Does the board demonstrate and evidence its engagement with the risk management process in any of the following ways?	
Meetings	80%
Formal reports	53%
Setting of policy	86%
Monitoring implementation of risk policies	60%
8. Is your board provided with relevant and up-to-date economic, business and market data for decision?	40%

Findings:

- Majority of banks' boards of directors have defined terms of reference for risk management, are aware of risk management requirements expected from them by the NBE, use risk management as a standing agenda item, spend fairly adequate time on and engage sufficiently with issues related to risk management.

- Nevertheless, full/part of board members in 87% of banks did not sit for training on risk management, suggesting an urgent need for risk management capacity building of board members; and
- Similarly, 60% of bank boards were not provided with relevant and up-to-date economic, business and market data for wise decision-making, implying a need for further work in strengthening management information system especially within the context of risk management.

ii. Structure and resources

Banks were asked nine questions under this heading. Purpose of these questions was to assess whether risk management function has received proper leadership, resources, monitoring system, etc

	"Yes" responses
9. Is risk management delegated to a subgroup, for example a risk management unit?	67%
10. If your response to question no. 9 is yes, is one key person responsible for risk management?	60%
11. Is organizational structure adequate for effective risk management function?	60%
12. Are human and financial resources allocated to risk management function?	80%
13. If your response to question no. 12 is yes, what is the quality and quantity of these resources?	
Human resources (adequate number & qualification)	100%
% of risk management budget in total budget:	

	0.14-0.43%	42%
	1.81-2.2%	25%
	NA[3]	33%

		“Yes” responses
14. To what extent are risk management staffs trained in risk management area?		
	Fully	27%
	Partly	33%
	Not at all	40%
15. Does risk management unit submit periodic report to senior management and board?		60%
16. If your response to question no. 15 is yes, how often and what does the report cover?		
Frequency:		
	Quarterly	90%
	Fortnightly	10%
Coverage:		
	Exceptions to policies, limits, compliance…	100%
	Risk level	89%
	Risk trend	89%
	Risk management weaknesses	67%
	Others	33%
	Recommendations	56%
17. Is risk considered by the following committees?		
	Board committee (Audit/risk management)	53%
	Senior management	80%

[3] Not available

Findings:

- Most banks responded that they have delegated risk management function, assigned relatively qualified risk management staffs to the function, and exercise risk reporting and deliberations.

- However, budget earmarked for risk management in 75% of banks is either relatively insignificant (0.14-0.43% of total budget), or the amount set aside is entirely unknown, suggesting that the function is largely overlooked; and

- Meanwhile, in 73% of banks, either only part of risk management staffs were trained in risk management areas, or no staff was trained at all, implying an immediate need for steps to be taken to bring all risk management staff on board.

iii. Strategies, policies and programs

Using five questions under this heading, our objective was to review whether banks have documented appropriate strategies, policies and programs related to risk management.

		"Yes" responses
18. Does your board have the following key risk management documents?		
	Strategy	40%
	Policy	87%
	Program	26%
	Procedure, or guideline	67%
19. If your response to question no. 18 is yes, are the documents approved?		
	Strategy by board	66%
	Policy by board	85%
	Program by the NBE	75%
	Procedure, guideline by board/CEO	90%

20. How often are the documents under no. 19 reviewed?		
Strategy:		
	Every 2 & 5 years	33%
	As required	67%
Policy:		
	Annually, every 2 and 5 years	54%
		"Yes" responses
	As required	46%
Program:		
	Annually and every 5 years	50%
	As required	50%
Procedures, guidelines:		
	Annually	50%
	As required	50%
21. Does the policy quantify and define the appetite for risk?		40%
22. If your response to question no. 21 is yes, which areas have limits/risk tolerances?[4]		
	a) Counterparty (single, related, etc) keep limits as set by the NBE	93%
	b) Geography	7%
	c) Product	27%
	d) Security	
	- Type	0%
	- Margin	13%
	e) Sector	33%
	f) Others[5]	13%

[4] Question modified during survey
[5] Off-balance sheet, loan to deposit ratio, liquidity ratio, limits on NPLs ratio, loan by contractual maturity (term), currency composition, etc

Findings:

- It is encouraging to see that policies and procedures are documented by majority of banks. However, 60% and 74% of banks have not yet documented risk management strategy and program, respectively. This suggests inadequate performance of board and senior management in these particular areas;
- Majority of banks having strategies, policies, programs and procedures related to risk management, have also secured approvals on the documents from relevant authorities. Also, it is good that majority of banks responded that they review their risk management policies annually, every 2 or 5 years. Nevertheless, 50% or above of banks responded that they review risk management strategy, program and procedure, "as required"; meaning, they lack timeframe to review the documents, limiting a proper means for accountability and control; and

- Unfortunately, there is general weakness in terms of defining appetite for risk. Majority (60%) of banks responded that their risk management policies do not define and quantify the appetite for risk, suggesting limited aspect of risk control. Even the vast majority (93%) of those 40% of banks who claimed to have policies with defined risk limits/tolerances, just use NBE limits for counterparties (single, related, etc) without having their own, or more than 3/4th of them failed to define limits for geography, product, security, sector and others. It is, therefore, imperative that there is an urgent need for further work in these areas.

iv. Communication

Banks were asked three questions under this heading to provide information on how risk management policies and practices were communicated internally.

	"Yes" responses
23. Does the bank share a common language that defines its appetite for risk?	40%
24. To what extent is risk management policy communicated internally?	

Fully	40%
Partly	40%
Not at all	20%
25. Are risk management reports and findings shared across staff?	40%

Findings:

- Results of survey indicate that as high as 60% of banks' internal communication of risk appetite and findings is low, implying a need for involving the wider staffs.

v. Appraisal and Reward

The intent of asking banks a question under this caption is to know to what extent the risk management process of banks is integrated with their HR management and policies including appraisal and reward systems.

	"Yes" responses
26. To what extent is risk management process integrated with HR management & policies including appraisal and reward system?	
Fully	13%
Partly	53%
Not at all	34%

Findings:

- Unfortunately, survey results show that risk management process, in the vast majority (87%) of banks, is either partly or fully not integrated with HR management and policies, for motivated behavioral change.

vi. Benefits and outcomes

The purpose of asking banks a couple of questions, under this heading, is to assess if banks appreciate benefits of risk management and whether they benchmark their process against external standards.

		"Yes" responses
27. On scale 1 (low) to 5 (high), to what extent does risk management benefit your business in the following areas?		
	Improved strategic planning (5)	70%
	Better business performance (5)	61%
	Increased regulatory compliance (5)	69%
	Improved internal control (5)	61%
	Improved risk impact likelihood (5)	62%
28. Have you benchmarked your risk management process, for example against other banks or against external standards?		80%

Findings:

- Fortunately, majority of banks appreciate benefits of risk management, and exercise benchmarking.

vii. Auditors

A couple of questions under this heading are designed to verify involvement of auditors in commenting on risk management effectiveness.

	"Yes" responses
29. Have your external auditors given their views on the effectiveness of your risk management process?	33%

30. Have your internal auditors given their views on the effectiveness of your risk management process?	40%

Findings:

- 77% and 60% of banks responded that external auditors and internal auditors, respectively, have not reviewed effectiveness of their risk management process.

viii. Risk identification and preparedness

With the following six questions under this title, our attempt was to evaluate whether banks have proper risk management tools in place to identify, measure, and control risk.

		"Yes" responses
31. Are risks in each of the following activities/products captured by risk management function?		
	Lending	87%
	Treasury	87%
	Investment	67%
	Retail banking	67%
	Transfer	67%
	Foreign	80%
	IT	80%
	Others (Procurement & HR)	7%
32. Have you ever conducted workshops to identify risks in each activity?		13%
33. Have you created risk registers?		40%
34. Do you exercise stress testing as a risk management tool?		13%
35. What is the share of insured assets[6] value in that of total assets?		
	40-69%	13%

[6] Net of loans made on clean basis, suspense accounts, stock, acquired assets, equity participation, cash above approved limit, etc

	70-89%	60%
	90-100%	27%
36. Do you have business continuity/disaster recovery/contingency plan?		
	For operational risk (including IT)	73%
	For liquidity risk	60%
	For other risks (credit, market, & reputation)	7%

Findings:

- Majority of banks responded that risks in all activities/products are captured by risk management function, except procurement and HR whose risks are not captured by 93% of banks;

- Results of survey show that insurance is effectively used by majority of banks as a risk management tool; although 87% of banks do not conduct workshop to identify risks in each activity, 60% of them did not create risk register, and 87% of them do not exercise stress testing as a risk management tool; and

- Likewise, majority of banks responded that they have continuity/disaster recovery/contingency plan in place for operational and liquidity risks; although, 93% of banks do not have one for other risks like market & reputation.

ix. Nature of risks facing banks

A couple of questions under this title are intended to rank key risks affecting banking business.

		"Yes" responses
37. Which three risks had most affected your bank in the last two years?		
	Credit risk	60%
	Operational risk	53%

	Liquidity risk	40%
38. Which three risks, do you think, will be key (most relevant) to your bank over the next five years?		
	Credit risk	100%
	Operational risk	80%
	Liquidity risk	80%

Findings:

- The survey revealed that credit, operational and liquidity risks have been dominant risks over the last two years, and will continue to be key risks over the next five years.

IV. CONCLUSION AND RECOMMENDATIONS

Results of survey suggest existence of some positive steps so far taken by banks to strengthen their risk management practices. These include: preparation of terms of reference for risk management, creation of risk management awareness, considering risk management as an agenda item and allotting adequate time for its deliberations by majority of bank boards.

Also, in large proportion of banks, risk management is delegated, risk management staffs are qualified, risk management findings regularly reported, risk management policies and procedures are developed and approved, risk management practice is benchmarked, risks in products/activities are captured, business continuity/contingency plans exist for operational and liquidity risks.

On the other hand, this survey unveiled a number of risk management weaknesses. Significant proportion of banks lack: training for board/risk management staff, up-to-date and relevant data for informed decisions, adequate risk management budget, risk management strategies and programs, timeframe to review risk management documents, risk limits, risk communication, risk management integration with HR management and policies, risk management audit review, and initiatives to identify risks.

Moreover, greater part of banks failed to capture risks related to procurement and HR, to create risk register, exercise stress testing, to put in place tools to effectively mitigate other risks like market and reputation.

To strengthen banks' risk management: i) the NBE should review the existing risk management guidelines and issue them to all banks; ii) banks should be required to produce risk management programs acceptable to the NBE by giving due attention to credit, operational and liquidity risks; and iii) the NBE should design and implement short-term training programs to banks' board members and risk management staffs.