



# CAACM

Caribbean Association of Audit Committee Members Inc.



# Beyond Numbers

APRIL 2011. Issue No. 3



## Meeting the Challenges of Governance, Risk and Compliance



By Steve Husk,  
FRSGlobal Chief Executive Officer

### Introduction

The current economic climate heightens the need for all financial services firms to accurately gauge required levels of regulatory compliance and economic capital in order to support their business strategy and risk appetite. More regulations are on the way, demanding increased transparency and more frequent and accurate information about company operations. Robust and comprehensive risk management, regulatory compliance, and efficient governance are therefore topical areas for

discussion at many financial institutions. What does this really mean for organisations?

### Compliance

The goal of the compliance process is to make sure that a financial services company meets all of the demands placed on it by the external institutions that make laws and regulations. It also provides a set of guidelines with regard to best practice and processes. Compliance is achieved through various controls that are defined and established to help organisations prevent or detect policy violations and to improve business processes throughout the organisation. Problems discovered using these controls often lead to the redesign of processes to better meet both business and compliance goals.

### Risk

Identifying, assessing, measuring and monitoring risks is fundamental to establishing business processes that can help companies manage risk

*(Continued on page 3)*

## What's Inside?

Meeting the Challenges of Governance, Risk and Compliance	....	Pages 1,3&4
CAACM Mission /Vision Statements	....	Page 2
The Practical Management of Market Risk	....	Page 5-7
Highlights from ERM Module 1 Training Workshop	....	Page 8
Notice Board	....	Page 9

## **BOARD OF DIRECTORS OCTOBER 2010 - JUNE 2011**

Mr. Allan Bierzynski  
Chairman  
Chairman, Audit Committee, **Caribbean Microfinance (Grenada) Ltd**  
**GRENADA**

Mr. Henry Mangal  
Deputy Chairman  
Company Director, **East Caribbean Financial Holding Company Ltd**  
**SAINT LUCIA**

Mr. Desmond Simon  
Secretary  
Chief Executive Officer, **CAIB Secretariat**  
**SAINT LUCIA**

Mrs. Nicolette Doherty  
Director  
Member, Audit Committee, **Global Bank of Commerce Ltd**  
**ANTIGUA**

Mr. Austen Gittens  
Director  
Internal Auditor, **Antigua Commercial Bank Ltd**  
**ANTIGUA**

Mr. Brian Royer  
Director  
Chairman, Audit Committee, **National Bank of Dominica Ltd**  
**DOMINICA**

Mr. Nigel Fulgence  
Director  
Member, Audit Committee, **1st National Bank St. Lucia Ltd.**  
**SAINT LUCIA**

## **FOUNDING MEMBERS**

NATIONAL BANK OF ANGUILLA LTD

GLOBAL BANK OF COMMERCE LTD

NATIONAL BANK OF DOMINICA LTD

DOMINICA ELECTRICITY SERVICES LTD

CARIBBEAN MICROFINANCE (GRENADA) LTD

REPUBLIC BANK (GUYANA) LTD

THE BANK OF NEVIS LTD

1ST NATIONAL BANK ST LUCIA LTD

EAST CARIBBEAN FINANCIAL HOLDINGS COMPANY LTD

ST LUCIA ELECTRICITY SERVICES LTD

NATIONAL COMMERCIAL BANK (SVG) LTD

DE SURINAAMSCHE BANK NV (DSB)

HAKRINBANK NV

DFL DEVELOPMENT FINANCE LTD

FIRST CITIZENS BANK LTD

FIRST CITIZENS ASSET MANAGEMENT LTD

REPUBLIC BANK LTD

## **CAACM VISION**

To be the recognized body in the Caribbean involved in developing the audit committee function.

## **CAACM MISSION**

The ultimate objective for the establishment of CAACM is to improve the investment environment in the Caribbean region and increase investors' confidence in the integrity of financial reporting and investor information through the continuous development of the audit committee function by:

- ◆ Providing educational programmes designed to improve the understanding of the roles and responsibilities of audit committee members;
- ◆ Developing codes of practices and templates for the proper functioning of audit committees;
- ◆ Distributing information of interest to audit committee members on a timely basis; and
- ◆ Providing a forum for audit committee members to exchange ideas and expertise on matters of common interest including the resolution of policy issues related to the evolution of standards and practices.

# News

## *Meeting the Challenges of Governance, Risk and Compliance*

*(Continued from page 1)*

with confidence while maximising their opportunities according to their strategy. Effective risk management enables companies to protect the value built within an organisation and can also create new value by identifying opportunities to build growth, increase competitive advantage and drive efficiencies.

### **Governance**

Good governance is about steering the company in the right direction as well as evolving policies and procedures and improving efficiency to achieve better alignment with corporate goals. Governance, when properly implemented, helps guide the evolution of a company. Governance processes help create orderly ways to evolve a company as well as improve program and change management across the board.

An enterprise-wide, systematic approach to governance, risk and compliance leads to a process that constantly deepens management understanding of what is going on in a business, while increasing confidence that risks are being managed and key business strategies are being efficiently executed. Such an approach creates a sustainable stream of high-quality information that can help the business turn strategy into actions, track and monitor risks, improve processes, enhance performance and innovation for developing new products and processes, and be a driver for business change. By integrating multiple risk capabilities, organisations can model and predict the impact of actions to ensure that tactical behaviour does not undermine future growth, reputation or viability.

### **Challenges**

In the past – and in some cases, the present - financial services companies have conducted their business using a silo approach. While streamlining the pre- and post-trade cycle was already underway before the Lehman Brothers default and the financial crisis that followed, it

was accelerated by that event and is now occupying board-rooms as never before. Managing information prepared at different frequencies makes comparisons difficult or even impossible, as with no proven way of aggregating data, many companies are unable to gain a company-wide view of risk. There is little transparency of the risks at an enterprise level, and generally, any formal focus on risk management is on the negative aspect rather than taking a proactive approach to strategic risk management. This fragmented approach to risk, with different departments doing their own thing, creates a false sense of security. Members of senior management may believe that their organisations are managing risk, but in fact, these organisations often lack any visibility or insight. This is precisely what happened at Lehmans. The only real perspective a firm has is the historical perspective, and managing a business based solely on looking out of the rear view mirror does not allow a business to move forward.

Straight-through processing or a more holistic approach to regulatory reporting?

By using a framework as offered by FRSGlobal to track, monitor and even model key risk indicators directly against business performance, a financial services company can begin to implement change across the enterprise to increase efficiency and improve business processes. This can lead not only to cost savings and an improved bottom line, but also to a higher degree of performance within the business. Compliance is not negotiable, how a firm manages risk can revolutionise the way to help to protect value, but putting the two together is the way forward.

Risk management today needs to provide automated monitoring of many key risk indicators as soon as certain thresholds are reached so that relevant risk information is constantly being identified, analysed and managed before the risks become loss events and negatively affect the business. By establishing a single platform to automate risk management processes

*(Continued on page 4)*

# News

## *Meeting the Challenges of Governance, Risk and Compliance*

(Continued from page 4)

across disparate systems enterprise-wide, multiple scenarios can be modeled for future projects or products. These scenarios can be effectively risk-adjusted and managed, before submitting the proposed plans to management and regulator.

Straight-through processing was an ongoing issue for firms during the 1980s and 90s, at this time it was felt that a single front-middle-back office solution was the answer to the problem of faster trading and risk management. However, in the late 90s focus shifted to the business of securitisation and product silos became even more entrenched.

Integrating compliance and risk management means we are going back to the idea of focusing on business processes that improve operational efficiency effectiveness while effectively managing risks and meeting regulatory reporting requirements for risk-based performance management to all internal and external stakeholders. In

other words they are two sides of the same coin. Strategy is the 'what'. Governance is the 'how'. Strategy management lays out the goals of the organisation as well as initiatives for turning those goals into action. Governance provides the rules, policies and applicable regulations that must govern those actions. Business planning is more effective when it is informed about the material risks to the business, and resources for mitigating those risks are allocated appropriately. Financial results need to be consolidated in a way that ensures compliance in order to be reportable. In each case, parallel business processes are utilising the same data for separate but related purposes.

Ultimately, all parts of the business interact and each has a dependency on the other.

SOURCE: [http://www.bobsguide.com/guide/news/2010/Nov/22/Meeting\\_the\\_challenges\\_of\\_governance%2c\\_risk\\_and\\_compliance.html](http://www.bobsguide.com/guide/news/2010/Nov/22/Meeting_the_challenges_of_governance%2c_risk_and_compliance.html))

### *"Investment Quote"*

*Experience taught me a few things. One is to listen to your gut, no matter how good something sounds on paper.  
The second is that you're generally better off sticking with what you know.  
And the third is that sometimes your best investments are the ones you don't make.*

*Donald Trump*

# News

## *The Practical Management of Market Risk*

Managing market risk is more than evaluating exposures and anticipating potential losses. Stressful market conditions like those during the 2008 credit crisis involve other issues: loss of liquidity, ballooning counterparty exposures and margin calls, forced sell-off of assets at deep discounts, etc. Although useful as a first line of defense, parametric Value at Risk (VaR) is not enough since it fails to take these knock-on effects into account - it is reactive in nature and deficient in measuring the full scope of portfolio risk.

Today's risk professional must utilize a diverse range of techniques to manage risk, including:

- VaR
- Stress tests
- Historical simulation
- Empirical distribution
- Monte Carlo simulation
- Various real-time analytics

### **Value-at-Risk (VaR)**

VaR limits are breached when something new has happened that is not mysteriously embedded in the trailing numbers—a liquidity crisis, bankruptcy, an unexpected economic number, etc. As a result the market instantaneously enters uncharted territory. VaR cannot anticipate such events, but rather assesses the risk given current conditions. However, VaR can still serve as an early warning.

Any significant change in VaR is a sign that either the correlations and volatilities have altered, or the risk attributes of a portfolio have changed. Thus, a significant movement in VaR from one day to the next signals the need for immediate investigation. There may be some unintended sector exposures, or sensitivities to the price of oil, short-term interest rates, or other factors. A change in VaR may not tell which factors one is exposed to, but it can warn of a new exposure.

### **Stress Tests**

- Should include all market inputs relevant to a portfolio and

strategy

- When simultaneously stressing multiple factors, the joint behavior under extreme conditions must be correctly incorporated in the scenario.

Example: A typical convertible arbitrage fund trading stocks, convertibles, equity options, bond futures and credit default swaps (CDS) would monitor:

- Equity prices
- Implied volatility
- CDS spreads
- Default risks
- Yield curve exposures

An appropriate stress test might be to drop the stock price ten per cent and increase the CDS spread by 200 basis points, simulating a sudden deterioration in credit quality. But what about implied volatility? For options an increase of five points would be appropriate to specify. For the convertible bond, the implied volatility is likely to drop as investors sell out of their bond positions. This is because the volatility arbitrage in convertible bonds is not as tight as it is with ordinary options, so liquidity issues can dominate. Thus the implied volatility corresponding to the same underlying stock can actually move in opposite directions, depending upon security type.

Stress tests should be carefully designed to properly approximate market dynamics of a particular holding, portfolio or strategy. Access to quality historical data plus personal expertise is critical, but a risk management system should enable user-specified stressing of underlying factors. If you can ask the question, you should be able to compute the answer.

### **Liquidity**

Under stressful conditions liquid securities become less so; the effect is magnified with securities that were illiquid to begin with.

There are two consequences:

- Effect on mark-to-market
- Possible need to unwind at unfavorable prices to meet margin calls

*(Continued on page 6)*

# News

## *The Practical Management of Market Risk*

*Continued from page 6*

To address these issues, positions need to be analyzed by liquidity buckets. An equity long-short fund will want to ensure that a sufficiently large position exists in its most liquid bucket to cover potential margin calls; the size will depend upon the existing degree of leverage.

### **Historical Simulation and the Empirical Distribution**

Historical time-series data of underlying risk factors (eg, stock prices) is used to:

- Compute correlations and volatilities
- Replay specific historical scenarios (eg the crash of 1987, etc.)
- Generate an empirical distribution

In the first case, the correlations and volatilities are used in a parametric VaR calculation. The second case is straightforward; however, the concept of empirical distribution may be unfamiliar. (Unlike parametric VaR, there is no attempt to fit a distribution to a bell-shaped curve. It just is what it is, fat tails and all.)

In a historical simulation, the positions in the portfolio remain static: no trading, no re-hedging. In a dynamic marketplace this may not be realistic. In an extreme situation one might stay the course if there were absolutely no liquidity, or if one were willing to make a huge bet that the market would recover. The empirical distribution makes no such assumption, as it assumes that each day begins with the current exposure.

### **Monte Carlo Simulation**

Monte Carlo simulation is akin to parametric VaR, only computed for nonlinear products. It depends upon the same inputs as VaR—volatilities and correlations of underlying risks—but takes convexity and optionality into account. If using Monte Carlo simulation consistently as part of a rigorous risk management protocol, be aware that it, like parametric VaR, relies upon an assumed distribution for the underlying risks. There-

fore Monte Carlo should be augmented by appropriate stress tests.

### **On-the-Fly Analytics**

In a dynamic market it is impossible to predict everything. Unanticipated situations, unexplained changes to P&L, or a market move in favor that is not yielding expected returns may arise. You should have the ability to perform on-the-fly analyses to ferret out what is going on so that you can suitably modify your trading strategies. With proper tools in place, ad hoc situations can be quickly and effectively investigated and analyzed. It is essential to understand everything you can about your portfolio.

Consider a long volatility book of options. The market has just undergone a sharp rally, yet mark-to-market is actually negative. Why? It might be explained by option positions in the “tails,” particularly out-of-the-money call options—a significant change in their implied volatility that has hurt P&L more than the benefit from the increase in underlying volatility. A calculation that returns only the vega (volatility sensitivity) of deep out-of-the-money options just prior to the rally can quantify the effect. Such an ad hoc calculation might be to compute the vega only if the delta (in absolute value) is less than five per cent, and otherwise ignore the position.

### **Hidden Exposures**

Determining exposure to a particular company, let alone sector, is not simple. Exposure can come from investments in stocks, CDS, and other securities with the same issuer as well as through ETFs. The stock may be a component of one or more ETFs, or it may be a component of an equity index on which a trader has sold options. It is important to be able to look through basket securities to their underlying components to properly assess exposures.

### **Conclusion**

Market behavior can change dramatically at any time, as has been witnessed both during the credit crisis and in our present

*(Continued on page 7)*

# News

## *The Practical Management of Market Risk*

*Continued from page 6*

state of sustained volatility. Risk management that turns upon an assumption of precise knowledge of the distribution of returns or is one-dimensional, such as VaR, is insufficient. Instead, diversify your risk management by establishing a risk management structure that utilizes a wide variety of tools appropriate to particular strategies that complement, augment and compensate for each other's weaknesses.

Risk cannot be boiled down to a single number. Portfolio risk is multi-dimensional and must be analyzed from a variety of perspectives, along with its behavior under many different circumstances (eg, stress tests). Designing meaningful stress tests requires experience, access to quality historical data, and an ability to calculate the effects of shifting several risk factors simultaneously. Historical simulations are helpful, but the ability to generate an additional empirical distribution will help avoid the "stay the course" assumption and give a complementary

evaluation of one's risk.

Remember: real-world risk management is an active profession. No matter how hard we may try to anticipate potential problems, the market is ultimately more creative than any of us. To successfully manage and mitigate risks in an uncertain world, it is imperative to have proper tools and procedures in place so that you can react and investigate in real time, as well as proactively probe for underlying "fault lines" that can negatively impact portfolios given a particular set of conditions. With robust systems, procedures and personnel in place, your firm will be better equipped to safely navigate through the next storm.

SOURCE: [http://www.bobsguide.com/guide/news/2010/Dec/7/The\\_practical\\_management\\_of\\_market\\_risk.html](http://www.bobsguide.com/guide/news/2010/Dec/7/The_practical_management_of_market_risk.html)

### *"Today's Quote"*

*When I was young I thought that money was the most important thing in life; now that I am old I know that it is.*

*Oscar Wilde*

*The Caribbean Association of Indigenous Banks Inc (CAIB) and Caribbean Association of Audit Committee Members Inc (CAACM) Convened its First Training Session for the Year in Enterprise Wide Risk Management - April 13-15 2011, Hyatt Regency, Trinidad*



*Left to Right: Back Row- Michael Green-Capita Financial Services, Filippo Alario- Belize Bank Ltd, Peter Quinn-Eastern Caribbean Amalgamated Bank, Paula Bleasdille- National Insurance Corporation, Jacqueline Holder-Signia Financial Group Inc, Randy Lewis-Eastern Caribbean Home Mortgage Bank, Bernard Thomas-National Bank of Dominica Ltd, Mohan Mahase- Belize Bank Ltd.*

*L-R: Front Row- Nellisa Anselm- National Bank of Dominica Ltd, Paul Trotman- St Christopher & Nevis Social Security Board, Wendy Ramautarsing- De Surinaamsche Bank N.V, Ashna Kamta- De Surinaamsche Bank N.V, Debra Williams-Eastern Caribbean Amalgamated Bank, Facilitator-Mr. Rawle Mitchell and Lesa Tyson- St Christopher & Nevis Social Security Board.*

**The Facilitator for the aforementioned training Programme was Mr. Mitchell, a Financial and Management Executive with over 20 years of progressively responsible leadership and industry experience. Mr. Mitchell has also conducted seminars and workshops in treasury and risk management and development, reorganized, and strengthened **Treasury, Risk Management, Supply Chain and Strategic Planning Operations** in order to maximize performance and profitability of various financial business enterprises. Mr. Mitchell has worked in senior managerial positions in the areas of **Investments, Treasury, Risk Management and Supply Chain Management**. His experience also spans the **Energy, Financial Services and the Hospitality sectors**.**

*This first ERM course model was aimed at enhancing participants' knowledge on the critical fundamentals of ERM, as well as equipping them with the necessary skills required to ensure that their business are implementing ERM in an effective way, in keeping with international best practices, more specifically, COSO issues. Delegates also benefited from breakout work sessions which focussed on resolving specific issues at their respective businesses. The CAIB/CAACM hope to convene Module 2 which will focus on Advance Issues in August this year.*

# NOTICE BOARD

## Upcoming Events

### Caribbean Association of Audit Committee Members Inc 5th Annual Meeting & Conference

**DATE:** July 13-15, 2011

**VENUE:** Hyatt Regency, TRINIDAD & TOBAGO

**Theme:** *“Adding Value, Not Bureaucracy: “The Role of the Audit Committee in Assessing Your Business Risk Profile, Risk Priorities and Governance Structures”*

**Register Now!**

**Register Now!**

DO YOU HAVE AN ARTICLE FOR SUBMISSION?  
THEN SEND IT TO US @ [caib@candw.lc](mailto:caib@candw.lc)  
Thank you.

*BEYOND NUMBERS is brought to you by: CAACM Officers:  
Chief Executive Officer - Mr. Desmond Simon  
Office Manager- Mrs. Mary Louis  
Administrative Officer I- Ms Cheryl Delice  
Administrative Assistant I- Ms Shannez Rattie*