HC-6.6 Risk Management

Bank-wide Risk Management Framework

HC-6.6.1 **Banks must establish a sound risk management framework commensurate with the bank's size, complexity and risk profile. A risk management framework must have the following key features:**

(a) Active Board and senior management oversight;
(b) Independent risk management function;
(c) A Board driven sound risk management culture that is established throughout the bank;
(d) Appropriate policy, procedures and limits;
(e) Comprehensive and timely identification, measurement, mitigation, controlling, monitoring and reporting of risks;
(f) Appropriate management information systems ('MIS') at a business and bank-wide level; and
(g) Comprehensive internal controls.

HC-6.6.2 More specifically, the risk management framework generally encompasses the process of:

(a) Subject to the review and approval of the board, developing and implementing the enterprise-wide risk governance framework, which includes the bank's risk culture, risk appetite and risk limits;
(b) Identifying key risks to the bank including material individual, aggregate and emerging risks;
(c) Assessing the key risks and measuring the bank's exposures to them;
(d) Ongoing monitoring and assessing of the risk taking activities, decisions and risk exposures in line with the board-approved risk strategy, risk appetite, risk limits and determining the corresponding capital or liquidity needs (i.e. capital planning) on an ongoing basis;
(e) Reporting to senior management, and the board or risk committee as appropriate, on all the items noted in this Paragraph including but not limited to proposing appropriate risk-mitigating actions;
(f) Establishing an early warning or trigger system for breaches of the bank's risk appetite or limits; and
(g) Influencing and, when necessary, challenging decisions that give rise to material risk.

Consultation

HC-6.6 Risk Management (Continued)

HC-6.6.3 **Senior management must establish a risk management process that is not limited to credit, market, IRRBB, liquidity and operational, but which incorporates all material risks. This includes reputational and strategic risks, as well as risks that do not appear to be significant in isolation, but when combined with other risks, could lead to material losses.**

Independent Risk Management Function and Chief Risk Officer

HC-6.6.4 **All banks must establish an independent Risk Management function and appoint a head of risk management function, referred to as Chief Risk Officer ('CRO') or any equivalent title. The function must be independent of the individual business lines and report directly to the Chief Executive Officer ('CEO') and have access to the bank's Board of Directors or its Audit or Risk Committees, without any impediment. The role of the CRO must be independent and distinct from other executive functions and business line responsibilities, and there must be no 'dual hatting' (i.e. the chief operating officer, CFO, chief auditor or other senior management personnel must not also serve as the CRO).**

HC-6.6.5 Branches of foreign banks operating in Bahrain should have the choice of having an in-house risk management function in Bahrain or outsource such role to their regional or Head offices.

HC-6.6.6 The CRO should have the ability to interpret and articulate risk in a clear and understandable manner and to effectively engage the board and management in constructive dialogue on key risk issues. The CRO should also not have any management or financial responsibility in respect of any operational business lines or revenue-generating functions. Interaction between the CRO and the board should occur regularly and be documented adequately. Non-executive board members should have the right to meet regularly - in the absence of senior management - with the CRO.

Consultation

HC-6.6 Risk Management (Continued)

HC-6.6.7

The CRO has primary responsibility for overseeing the development and implementation of the bank's risk management framework. This includes the ongoing strengthening of risk management staff skills and enhancements to risk management systems, policies, processes, quantitative models and reports as necessary to ensure that the bank's risk management capabilities are sufficiently robust and effective to fully support its strategic objectives and all of its risk-taking activities. The CRO is responsible for supporting the board and the Risk Committee, as appropriate, in its engagement with and oversight of the development of the bank's risk strategy, risk appetite statement ('RAS') and for translating the risk appetite into a risk limits structure.

HC-6.6.8

The risk management function must have access to all business lines that have the potential to generate material risk to the bank as well as to relevant risk-bearing subsidiaries and affiliates.

HC-6.6.9

The CRO, together with management, must be actively engaged in monitoring performance relative to risk-taking and risk limit adherence. The CRO's responsibilities also include managing and participating in key decision-making processes (e.g. strategic planning, capital and liquidity planning, new products and services development and compensation design and operation).

HC-6.6.10

The CRO must have sufficient organisational stature, authority, seniority within the organisation and necessary skills to oversee the bank's risk management activities.

HC-6.6.11

Appointment, dismissal and other changes to the CRO position must be approved by the board or its Risk/ Audit Committee. If the CRO is removed from his or her position for any reason, this must be disclosed publicly. The bank must also discuss the reasons for such removal with the CBB. The CRO's performance, compensation and budget must be reviewed and approved by the board or its Risk/ Audit Committee.

Consultation

HC-6.6 Risk Management (Continued)

Board Risk Committee

HC-6.6.12 Further to HC-1.8.1, banks shall establish a board risk committee composed of at least three independent directors, if deemed necessary by their boards, and keeping in view their size, complexity and risk profile. Such board risk committee should be responsible for supporting the board in its oversight and decisions related to the bank's risk management framework.

HC-6.6.13 **Where a bank establishes a risk committee, it must meet the following requirements:**

(a) Must be chaired by an independent director;
(b) Include a majority of members who are independent of day to day risk taking activities;
(c) Include members who have experience in risk management issues and practices;
(d) Develop a committee charter which among other matters include its role in the discussions of risk strategies, both at an aggregated basis and by type of risk and make recommendations to the board thereon, and on the risk appetite and risk limits;
(e) Review and revise as may be required, the bank's policies from a risk management perspective, at least annually;
(f) Review and recommend the appointment or removal of Chief Risk Officer; and
(g) Oversee that the bank has in place processes to promote the bank's adherence to the approved risk policies.

Role of Board and Senior Management

HC-6.6.14 **The Board must define the bank's risk appetite and ensure that the bank's risk management framework is aligned with the bank's strategic, capital strategies and financial plans and compensation practices and includes detailed policy that sets specific bank-wide prudential limits on the bank's activities. The bank's risk appetite must be clearly conveyed through an RAS that can be easily understood by all relevant parties: the board itself, senior management and bank employees.**

Consultation

HC-6.6 Risk Management (Continued)

HC-6.6.15 **The bank's RAS must:**

(a) Include both quantitative and qualitative considerations;

(b) Establish the individual and aggregate level and types of risk that the bank is willing to assume in advance of and in order to achieve its business activities within its risk capacity;

(c) Define the boundaries and business considerations in accordance with which the bank is expected to operate when pursuing the business strategy; and

(d) Be communicated effectively throughout the bank, linking it to daily operational decision-making and establishing the means to raise risk issues and strategic concerns across the bank.

HC-6.6.16 Developing and conveying the bank's risk appetite is essential to reinforcing a strong risk culture. The risk governance framework should outline actions to be taken when stated risk limits are breached, including disciplinary actions for excessive risk-taking, escalation procedures and board of director notification.

HC-6.6.17 The development of an effective RAS should be driven by both top-down board leadership and bottom-up management involvement. While the definition of risk appetite may be initiated by senior management, successful implementation depends upon effective interactions between the board, senior management, risk management and operating businesses, including the chief financial officer (CFO).

HC-6.6.18 **The Board must ensure that:**

(a) A sound risk management culture is established throughout the bank;

(b) Appropriate limits are established that are consistent with the bank's risk appetite, risk profile and capital strength, and that are understood by, and regularly communicated to, relevant staff;

(c) Policy and processes are developed for risk-taking, that are consistent with the Risk Management Strategy and the established risk appetite;

(d) Uncertainties attached to risk measurement are recognised; and

(e) Senior management is taking all necessary steps to monitor and control all material risks consistent with the approved strategies and risk appetite.

Consultation

HC-6.6 Risk Management (Continued)

HC-6.6.19

The Board of Directors and senior management must possess sufficient knowledge of all major business lines to ensure that appropriate policy, controls and risk monitoring systems are implemented effectively. They must have the necessary expertise to understand the activities in which the bank is involved – such as securitisation and off-balance sheet activities – and the associated risks. The Board and senior management must remain informed, on an on-going basis, about these risks as financial markets, risk management practices and the bank's activities evolve. In addition, the Board and senior management must ensure that accountability and lines of authority are clearly delineated.

HC-6.6.20

Before embarking on new or complex products and activities, the Board and senior management must identify and review the changes in bank-wide risks arising from these potential new products or activities and ensure that the infrastructure and internal controls necessary to manage any related risks, are in place. Senior management must understand the underlying assumptions regarding accounting treatment, business models, valuation and risk management practices. In addition, senior management must evaluate the potential risk exposure if those assumptions fail.

HC-6.6.21

As part of the Board members annual training program, banks must include training to enable Board members to better analyse risk and question strategic decisions, policy and transactions. Banks must also provide adequate training for all staff across the business units on risk management related matters.

Policy, Procedures, Limits and Controls

HC-6.6.22

A bank's policy and procedures must provide specific guidance for the implementation of broad risk management strategies and must establish, where appropriate, internal limits for the various types of risk to which the bank may be exposed. These limits must consider the bank's role in the financial system and be defined in relation to the bank's capital, total assets, earnings or, where adequate measures exist, its overall risk level.

Consultation

HC-6.6 Risk Management (Continued)

HC-6.6.23

A bank's policy, procedures and limits must:

(a) Provide for adequate and timely identification, measurement, monitoring, control and mitigation of all risks, including the risks posed by its lending, investing, trading, securitisation, off-balance sheet, fiduciary and other significant activities at the business line and bank-wide levels;

(b) Ensure that the economic substance of a bank's risk exposures, including reputational risk and valuation uncertainty, are fully recognised and incorporated into the bank's risk management processes;

(c) Be consistent with the bank's stated goals and objectives, as well as its overall financial strength;

(d) Clearly delineate accountability and lines of authority across the bank's various business activities, and ensure there is a clear separation between business lines and the Risk Management function;

(e) Escalate and address breaches of internal position limits;

(f) Provide for the review of new businesses and products by bringing together all relevant risk management, control and business lines, to ensure that the bank is able to manage and control the activity, prior to it being initiated; and

(g) Include a schedule and process for reviewing the policy, procedures and limits, and for updating them as appropriate.

Monitoring and Reporting of Risk

HC-6.6.24

A bank's MIS must provide the Board and senior management with timely and relevant information concerning their risk profile, in a clear and concise manner. This information must include all risk exposures, including those that are off-balance sheet. Senior management must understand the assumptions behind, and limitations inherent in, specific risk measures.

HC-6.6.25

Banks must establish appropriate risk management methodologies, tools and models and systems commensurate with the nature and complexity of their business.

HC-6.6.26

Where banks use models to measure components of risk, they must establish model governance frameworks including regulatory validation and testing.

Consultation

HC-6.6 Risk Management (Continued)

HC-6.6.27 Banks must have information systems that are adequate (both under normal circumstances and in periods of stress) for measuring, assessing and reporting on the size, composition and quality of exposures on a bank-wide basis across all risk types, products, countries, region, etc. and counterparties. These reports must reflect the bank's risk profile, capital and liquidity needs, and are provided on a timely basis to the bank's Board and senior management. A bank's MIS must be capable of capturing limit breaches, and there must be procedures in place to promptly report such breaches to senior management, as well as to ensure that the appropriate follow-up actions are taken.

HC-6.6.28 Risk management framework must be frequently monitored and tested by both internal audit, as well as third–party consultants, other than the bank's external auditors.

HC-6.6.29 The CEO must consistently remind staff, through a regular process, of the risk management requirements and enhance a common understanding of these requirements across the bank in order to create a culture of risk awareness.

Consultation

HC-6.6 Risk Management (Continued)

Independent Review

HC-6.6.30 Banks must ensure that the risk management framework is subject to independent review by the internal auditor, on an annual basis, and a third party consultant, other than the external auditor, every 3 years. The review must cover, at a minimum, the following:

(a) The appropriateness of risk appetite/tolerance levels and capital planning;
(b) The strength of the internal control infrastructure, given the nature, scope and complexity of the bank's business;
(c) The appropriateness of third-party inputs or other tools used for management information purposes, such as risk measures and models.
(d) The identification of large exposures and risk concentrations;
(e) The accuracy and completeness of data input into the assessment process;
(f) Model governance and model validation procedures where models are used for computation of risk measures or estimates;
(g) The reasonableness and validity of scenarios used in the assessment process; and
(h) The use of stress-testing, including an analysis of the underlying assumptions and inputs.

HC-6.6.31 More specifically, the bank must undertake reviews referred to in HC-6.6.30 with regards to the following individual areas that are relevant to the risk management framework:

(a) ICAAP Framework referred to in Module ICAAP;
(b) Capital adequacy requirements under Module CA;
(c) Recovery and resolution planning and RRP documents referred to in Module DS;
(d) Credit risk management framework and compliance with Module CM;
(e) Operational risk management framework and compliance with Module OM;
(f) Interest rate risk in the banking book framework referred to in Module RRRBB; and
(g) Stress-testing framework included in Module ST.

Consultation

HC-6.6 Risk Management (Continued)

HC-6.6.32

In the case of internal audit reviews, banks must ensure the following:

(a) The independent review team possesses the necessary technical capabilities to perform the independent review in order to provide an effective challenge to persons responsible for the design and implementation of the framework of policies, procedures, systems and tools;
(b) The results of the independent review are reported to the Board and senior management of the bank; and
(c) The results of the independent review are made available to the CBB, upon request.

Consultation