Risk management in the Reserve Bank

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In late 1998 a new department – the Risk Assessment and Assurance Department – was established within the Reserve Bank. This article introduces the role and activities of the Department.

1 An overview of Reserve Bank risk

When considering risk in the Reserve Bank it is useful to stylise or categorise risk into the following three general headings; reputational risk, balance sheet risk and operational risk.

The Bank is very sensitive to what it thinks of as reputational risk. Its concern about reputation flows from the fact that it is a public institution with important responsibilities for stability in the value of money, the soundness and efficiency of the financial system and the issue of legal tender (ie notes and coin). All of these matters have direct impact on all citizens and the credibility and reputation of the Bank is an important factor in the successful fulfilment of these responsibilities.

The Bank's balance sheet risk (or risk of major financial loss) arises mainly from its role as manager of a large part of the Government's foreign exchange reserves and the investment of funds received from the issue of notes and coin. The Bank's holdings of foreign exchange reserves total about NZ$5 billion and need to be managed with appropriate recognition of interest rate risk, credit risk and foreign exchange risk. The investment of funds from the issue of notes and coin (totalling over $2 billion) also requires appropriate consideration of interest rate risk and credit risk.

Operational risk is the possibility that errors are made in the day-to-day activities of the Bank that could damage the Bank's reputation and/or result in financial loss. This risk is primarily managed by comprehensive internal controls over the operational procedures.

As might be expected, the Bank is quite risk averse, reflecting its perception of the large negative impact on its ability to fulfil its responsibilities should it suffer material financial losses or damage to its reputation.

2 General philosophy

The Bank's general philosophy is that risk management is an integral part of the general management task and is the responsibility of day-to-day business management. This general philosophy was reconsidered and reaffirmed when the Risk Assessment and Assurance Department was formally established in late 1998. The debate was about the extent of responsibilities for the new department; would it be responsible for the management of risk or the monitoring of risk management? We concluded the latter, and hence the deliberate choice of name for the department: Risk Assessment and Assurance.

Given that risk management is the responsibility of business management – it is difficult to imagine a "management" role that does not include "risk" management as a core element – it is necessary to have an understanding of management generally to get a better picture of risk management in the Bank.

The Governor is Chief Executive and Chair of the Board. There are two Deputy Governors, and reporting to them are nine senior executives responsible for the functions carried out by the Bank. This level of organisational structure and the various functions and internal services are recorded in detail of the 1998/99 Annual Report (page 7).

Some comment is made in the Annual Report about risk management but no comment is made about the role played in risk management (and management generally) by a number of key committees. The Bank is a small organisation with a small number of experienced senior executives. To help ensure it gets the most benefit from the small number of knowledgeable experienced people, the Bank makes extensive use of committees. The committees are advisory to the Governor rather than decision-making although it is common for the Governor, or the person to whom he has delegated authority, to state their recommendations on items in the course of a committee meeting.

The committees are:

- The Monetary Policy Committee (MPC) which meets weekly to consider economic developments as they affect the Bank's monetary policy responsibilities.
- The Financial System Oversight Committee (FSO), which meets monthly to consider policy issues relating to the Bank's responsibility for financial system soundness and efficiency.
- The Risk Management Committee (RMC), which meets monthly to consider issues arising from any concerns about aspects of the Bank's activities that could create greater risk than is considered acceptable. This committee is described in more detail in section 3.
- The Reserves Oversight Committee (ROC), which meets quarterly to consider the performance of the foreign reserves management activity.
- The Governor's Committee (GC), which meets weekly to consider issues arising from the management and day-to-day operation of the Bank and provides an opportunity for departments to alert each other to significant events in the immediate future.
- The Communications Committee which meets weekly to consider public communications issues and the day-to-day matters arising from that.

The above committees are chaired by either the Governor or one of the two Deputy Governors and are actively used as points of focus to ensure all aspects of issues get addressed (including any risks involved). The key determinant in participation is knowledge of and responsibility for the subject under discussion. Participation is drawn from across departments and from all levels of staff.

In addition to the above management committees, there are also two Board committees which fulfil this role; the Audit Committee and the Registry Committee. They both make a considerable contribution to risk management in the Bank.

So, in terms of the general philosophy that risk management is an integral part of day-to-day business management, the Bank reinforces that philosophy by an active committee structure with participants who include other than those directly responsible for the issues. This greatly improves the likelihood that all aspects (including any risk element) of an issue or policy are adequately considered before decisions are made.

3 Risk Management Committee

The charter of the Risk Management Committee (RMC) describes its role as "providing advice to the Governor by:

- taking a *comprehensive* approach to the management of risk in the Bank;
- ensuring appropriate risk management is incorporated in *strategic* initiatives as well as the day-to-day operational activities of the Bank;
- ensuring that a *systematic* approach is taken to risk management throughout the Bank; and
- ensuring that a *proactive* approach is taken to risk management throughout the Bank."

The Risk Assessment and Assurance Department is responsible for managing the Risk Management Committee agenda. This involves both initiating issues as well as inviting issues from throughout the Bank each month as part of the agenda compilation process. Issues before the committee are tracked through the use of an Issues Register. Each month committee considerations include progress on items in the Issues Register as well as any specific papers for that particular meeting.

As indicated by its charter, this committee has a Bank-wide role in helping to ensure proper attention is given by management to the risks faced by the Bank.

4 Specific responsibilities

In addition to the general philosophy as described above, the Bank also has two organisational units with specific responsibilities in relation to monitoring and management of risk.

Included in the Financial Markets Department is the Risk Unit. The Financial Markets Department is responsible for both domestic and foreign financial market activity and manages the Bank's balance sheet risk. The Risk Unit provides specialised financial market risk management advice within the department. This includes recommendations on interest rate risk, credit risk and liquidity risk limits and the development of specialised measures in this area such as value at risk.

The other organisational unit responsible for risk monitoring (but not directly for risk management) is the Risk Assessment and Assurance Department which is described in section 5.

In addition to the above, the Bank has also established a Reputational Risk Working Group chaired by the Corporate Affairs Manager. This working group is identifying a number of issues that, if they were to occur, would damage the reputation of the Bank. The purpose of identifying the issues is to consider what core information it would be necessary to have on hand to publicly respond to the issue. The focus of the working group is managing the public communication to minimise any unjustified damage to the Bank's reputation.

5 Risk Assessment and Assurance Department

The Risk Assessment and Assurance Department (RAA) in its current form was established in late 1998. It incorporated the previous Audit Services group and differs from previous arrangements in that it is explicitly mandated to take a comprehensive, strategic, systematic and proactive approach to the monitoring of risk management in the Bank.

It is a small group with an establishment of six persons.

There are two streams of activity. First, the audit services work. This involves programmed internal audit activity. Each year audit tasks are ranked taking into consideration the risk exposures of the various activities and the work scheduled for the year. The frequency of audit within that cycle varies depending on the ranking of the activity. All work results in a written report to the Deputy Governor responsible for that area of Bank activity. In addition, if there is a major item of concern that should be drawn to the attention of the Governor, he also receives a copy of the report. The reports contain an overall opinion on the outcome of the audit work, list any issues arising from the audit and incorporate management's comments on these issues. Any commitments to make changes as the result of the audit are tracked to confirm they are made in the time-frames agreed.

In addition there is a monthly audit services report which summarises any issues dealt with during the month and reports on progress on the audit programme. This report goes to the Governor, the Chair of the Audit Committee of the Board of Directors, the external auditors and the two Deputy Governors, with whom it is also discussed on a face to face basis. The Manager, Audit Services also has a direct right of access to both the Governor and the Chair of the Audit Committee on any issues the manager considers should be dealt with in that way.

The Audit Services Group, a well-established part of RAA, plays an important role in monitoring risk management throughout the Bank.

The second stream of activity is the "non-routine" work. The reconstitution of the Department has provided a little more opportunity to manage this work separately.

The approach taken to the second stream of work to date has been to identify an appropriate risk management framework and to deal with a number of specific issues.

After some investigation of the various frameworks available, it was decided to adopt as the Bank's framework the New Zealand/Australian Standard on Risk Management – AS/NZS 4360:1999. This recently reviewed standard seemed to provide a sufficiently generic, yet robust, approach to be a useful base for the Bank.

The specific issues have included:

- Proactive Problem Management (PPM). This is a Bankwide requirement for Chief Managers to advise their Deputy Governor of any significant or material issues that have occurred that could adversely impact on achieving their functional objectives. It is an extension and refinement of an earlier formal error reporting requirement that existed in some parts of the Bank. Its purpose is to give Governors a "heads up" on important unexpected issues, and it provides an opportunity for Governors to provide immediate advice.
- Legal Advice Sign-off. This is a sign-off required if internal

or external legal advice is sought by Bank staff on any contractual undertaking. It is in a standardised form and has two important elements. First, the Bank person seeking the sign-off confirms to the legal adviser that the document concerned contains all of the Bank's "business" requirements. Secondly, it requests advice from the legal adviser on any other issue or liability that the Bank should be aware of in relation to the contractual undertaking.

- Project Management Methodology. The Bank does not have an established project management methodology although it undertakes a significant number of both operational and policy projects each year. This work is to establish a methodology with a graduated degree of complexity to be used in the management of all reasonably sized projects in the Bank.
- Official Cash Rate (OCR) Security. This was a review of the existing security arrangements over the release of the OCR given the sensitivity of the information and the damage that would be caused to the Bank's reputation if this information were released prematurely.

The "non-routine" work also includes responsibility for managing the Risk Management Committee agenda as noted in section 3.

6 General conclusion

The key to success in risk management is adequately considering both the opportunities and the negative outcomes of a course of action and coming to a balanced view. The likelihood of coming to a balanced view is enhanced by the use of structured processes.

What constitutes a balanced view in the case of the Bank must be considered in terms of our role in New Zealand's financial system and our social and political environment.

Having risk management as an integral part of core business management helps ensure both opportunities and threats are adequately considered. The separate risk monitoring role of the Risk Assessment and Assurance Department, together with the wide range of advice from the Bank committee structure, are important elements in achieving a balanced view.