SmartLessons
real experiences, real development

A Thousand Cups of Tea: Strengthening Risk Management and Governance at SandBank*

SandBank is dealing with more than its share of challenges—and taking on some new ones. Not only must the bank cope with the global financial crisis, but it must also operate in a highly volatile political environment. On top of this, SandBank has been transitioning through an unexpected change in leadership at the chairman/chief executive officer level. Yet while the rest of the global financial sector experienced sharp profit declines, SandBank recorded remarkable growth of 15 percent. But this was not good enough for Chairman and CEO Mr. H. Habib, who recently took the reins of SandBank; he wanted to take risk management to another level—to assess his bank's risk management and governance practices against international standards.

BACKGROUND

SandBank is the largest non-foreign bank in the country (many of the banks operating there are from neighboring countries), accounting for nearly 20 percent of all credit facilities and about 15 percent of all deposits in the country. The bank has experienced sharp growth in the past 18 months, with both assets and deposits growing more than 20 percent. It currently operates the largest network of branches in the country and employs nearly 800 staff. Because of SandBank's extensive network and strategic importance as a "local" catalyst to outlying territories, IFC made a 5 percent equity investment in the bank in 2008.

Looking forward, SandBank is expecting continued growth, introduction of new product lines and possible expansion into other markets. It is because of this anticipated growth that Mr. Habib wanted to be sure his bank's current risk-management and governance infrastructure could keep up with the bank's ambitions. In May 2009, SandBank engaged IFC Advisory Services in the Middle East and North Africa to assist.

Following are a few lessons, touching first on our IFC team preparation and then on the actual client work.

LESSONS LEARNED

1) Put the right people in the right place at the right time: don't let internal organizational structures and/or limitations drive the solution. When building a tailor-made value proposition for the client, draw upon all the expertise available within IFC.

Mr. Habib, who spent many years working for two major global banks prior to joining SandBank, understood that effective risk management permeates the entire enterprise. That's why he wanted a top-to-bottom review of the bank, from board functions down to specific branch procedures.

A diverse team was assembled to respond to the client's needs. The team, led by the banking advisory program in the Access to Finance pillar, also included a corporate governance specialist from the Corporate Advice pillar. The combination of the two disciplines was critical to building the value proposition for

*NOTE: The name of the client and the country of operation have been altered to retain client confidentiality.

SandBank. The team was able to use tools and methods from both practices, making its approach to assessing SandBank more comprehensive.

2) By putting the right people in the right place at the right time and not letting internal silos get in the way, a couple of related lessons emerged.

First, spend ample time upfront determining how best to create a combined approach from different methodologies, and then divide responsibilities among team members. Prior to the site visit, the team met to do just that (see diagram). Broadly, Banking Advisory went into depth on SandBank's core banking and risk-management operations, such as credit risk, market risk, and treasury management. Corporate Governance focused on board issues and other key governance practices, such as information disclosure, shareholder relations, and family governance. The whole team collaborated on defining a new risk-management organizational structure and assessing operational risk and control areas, such as audit, compliance, internal control, human resources, and information technology. The team then defined documentation needed from the client (such as annual reports, financial statements, various policies and procedures) and the list of interviewees. The interviewees list was extensive, covering a majority of board members, numerous management staff, branch staff, and external parties (for example, external auditor, bank regulator). Planning the schedule of interviews was critical—especially since many of the key staff still sit in the outlying areas of the country and were available only via video conference. This upfront planning helped orchestrate the site visit and ensure that the team could cover all areas of the combined approach relatively smoothly and efficiently.

Second, as important as it is to clearly divide responsibilities upfront, it is equally important to collaborate on client interviews whenever possible.

ACCESS TO FINANCE AND CORPORATE ADVICE: A COMBINED APPROACH

For example, CG took the lead in interviewing board members, and BA led the detailed risk-management discussions with various management-level staff. However, most of the meetings included both BA and CG, which brought a variety of perspectives to the discussions and allowed team members to understand the complete risk-management framework throughout the bank. For example, CG could understand the detailed risk-management processes that ultimately feed into the information provided to the board, and BA could appreciate the board's points of view on management-level processes in the organization. Having this holistic picture helped the team formulate an integrated set of recommendations, from the board level down to the individual-unit level.

3) What works today may not work tomorrow: assess the effectiveness of current processes, and build on them where possible—but, more important, anticipate the client's future requirements as you draft recommendations.

To its credit, SandBank had already made strides in improving its risk-management activities. For example, in the area of operational risk, SandBank had recently shifted most of its key operating systems from a part of the country where the bank originated to the business capital as a way of improving business continuity and avoiding political unrest. And even though many of its key managers still sit in the outlying regions, the bank has not missed a single day of operation this year.

However, the purpose of this project was not only to assess the current effectiveness of a particular practice but also, more importantly, to consider what will be needed in the future. So, even though many of the bank's current practices may be sufficient for today's business context, they might not be adequate to support the bank's increasing volume, evolving products, and ambitions for expansion. Therefore, the IFC team's line of questioning aimed not only at understanding the current processes but also at anticipating future requirements.

For example:

- Given the strategic direction of the bank, including possible expansion beyond the country's border, does the board have the right structure and skill sets to guide the organization?
- Given the likely volume increase of credit facilities (the loan-to-deposit ratio today is only about 30 percent), are the credit processes properly designed and controlled?
- Given the development of new products, are the front and back offices prepared to support these new types of transactions?
- Given the continued expansion of branches, is the bank adequately prepared to address the challenging HR needs?

These and many other such questions helped the IFC team identify a number of improvement opportunities. Altogether, 42 recommendations emerged, including 22 with high priority. The recommendations were first presented to the senior management team during a four-hour work session and then to the full board of directors. In general, SandBank received the recommendations well and intends to move forward aggressively. However, given the breadth and depth of the recommendations, the biggest challenge for the bank was to determine which changes to pursue first. The IFC team assigned priorities (high, medium, low) to each recommendation to help SandBank develop a roadmap for the improvements. Based on this roadmap, SandBank has begun its journey toward stronger risk-management and governance processes that will support the bank's future expansion.

4) A thousand cups of tea: help the client develop formal processes to handle future volume—but also retain some elements of the personal culture that has brought the client this far.

Credit risk management was one of the key focus areas for the assessment. The team evaluated SandBank's entire credit cycle—from loan origination to loan payoff. During the credit-cycle assessment, Middle East and North Africa A2F leader Jim Gohary asked a SandBank branch manager how he assessed a client's creditworthiness. The branch manager responded that he sits down with each client and has a cup of tea, and this informal, personal discussion gives him good insight into the client's background and creditworthiness. Jim acknowledged that this kind of insight is indeed valuable, and it is in the spirit of "know your client" risk-management principles. But what happens, Jim asked, when 1) SandBank expands its loan volume, as it is expecting to do; and 2) SandBank strives for more proactive credit monitoring, whereby creditworthiness is reviewed on an ongoing basis throughout the term of the loan—not just once at origination? Suddenly, a single cup of tea grows into a thousand cups of tea.

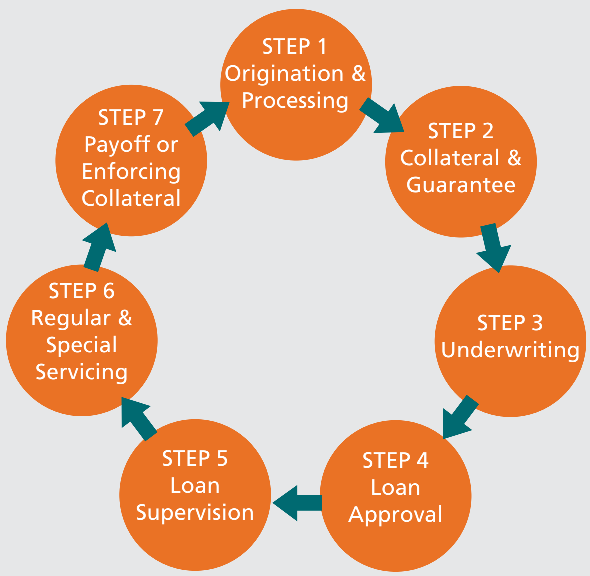
The informal approach alone is not sustainable as the portfolio grows in size and complexity. It should be complemented with more formal and routine credit-review processes, used consistently across the bank.

For example, the IFC team recommended a structured credit-review process with clear procedures on activities such as credit underwriting, collateral review, credit scoring, and credit pricing. Credit scoring (rating a client's risk according to a defined methodology and specific criteria) will enable SandBank to take a more risk-based approach to credit risk management by focusing more attention on, and exerting more control over, loans rated as having higher risk. In addition, this approach will help SandBank better understand its total capital at risk across the entire portfolio, and ensure that it is in line with the bank's overall risk appetite. The IFC team also recommended a more robust portfolio-monitoring process, to ensure that credit risk is monitored routinely and reported to senior management and the board in an aggregated format.

HIGHLIGHTS OF KEY RECOMMENDATIONS

- Establish two **new board committees** for risk management and HR/nominations to complement the existing Audit and Investment Committees.
- Strengthen **board composition** by seeking two or three outside directors with backgrounds in finance/accounting, risk management, and regional banking.
- Elevate risk management in the organization by creating a **chief risk officer** position that reports directly to the CEO and interacts regularly with the board Risk Management Committee.
- Reorganize the bank so that all **risk management operations** come under the CRO to achieve coordinated, enterprise-wide improvement in the management of all types of risk.
- Formalize the bank's **credit risk management** processes, including development of a credit scoring system and capital allocation techniques.
- Establish an **Asset Liability Committee** to help plan and manage assets and liabilities in a coordinated fashion (for example, term matching).
- Strengthen **investment operations** by introducing a formal investment strategy to manage the bank's significant liquidity (loan-to-deposit ratio is less than 40 percent).
- Institute a risk-based approach for **internal audit** to ensure that all types of risk (not just credit) are addressed and that audits are focused on the high-risk areas.
- Strengthen the **HR function** to go beyond transaction processing and become more of a strategic partner to the CEO to help manage the bank's evolution.

THE CREDIT CYCLE—A KEY AREA OF FOCUS FOR THE PROJECT



Yet, at the same time, the IFC team encouraged the bank to retain the cup of tea approach in the branches, to be sure that loan officers are dedicated to particular clients on a personal level. This practice will help SandBank maintain its high level of customer service and strong foothold in local communities. It will also enhance the bank's management of credit risk by enabling loan officers to stay abreast of client developments and to anticipate events before they occur. SandBank fully endorsed these recommendations and many others like them that were aimed at adding structure to the rapidly growing bank without losing that personal touch and community outreach.

CONCLUSION

The IFC team is now helping SandBank implement many of these recommendations. This process will take considerable time, given the enterprise-wide scope of the effort. Many of the board-level changes will be implemented in the near term, while many of the operational changes (for example, restructuring the credit risk functions) will take several months to become fully effective. However, the tools and lessons from this project have immediate relevance for other MENA advisory projects aimed at helping banks improve their risk management and governance processes. For example, a similar effort is taking place for a bank in Yemen and there is a possibility of one in Afghanistan.

A thousand cups of tea came to symbolize a transition process common to many banks in the region—an ambitious bank moving into its next generation of operation, while at the same time trying to preserve its founding roots. A transition that, once achieved at SandBank, will undoubtedly make Mr. Habib's cup of tea taste a bit sweeter.

ABOUT THE AUTHORS

Jim Gohary, Principal Operations Officer responsible for the Access to Finance Pillar in the Middle East and North Africa region, joined IFC in the summer of 2008, having previously worked at GE Capital, Royal Bank of Canada and USAID.

Chris Razook, Senior Operations Officer for the IFC MENA Corporate Governance Program, has been with IFC since early 2008 and with the World Bank Group since 2006. Prior to 2006, Chris worked in the private sector for PricewaterhouseCoopers and IBM.

APPROVING MANAGER

Jesper Kjaer, Senior Manager, IFC Advisory Services in MENA

September 2009