# GOVERNANCE, RISK MANAGEMENT AND COMPLIANCE IN TURBULENT TIMES


## Dr. Ranee Jayamaha

Deputy Governor
Central Bank of Sri Lanka


## 1. Recent Turmoil in Financial Markets

**1.1** The world financial markets have undergone significant disturbances and tremendous challenges since mid 2007 and thus far in 2008: the unprecedented high oil and commodity prices and related macro economic disturbances have adversely affected the developing and emerging countries more severely than others. Hard on the heels of economic woes, bad lending decisions, which surfaced during the sub-prime crisis in the US, are still creating issues across Europe and other financial markets. In addition, the liquidity mismatch related Northern Rock crisis in the UK has raised serious regulatory issues, while large scale frauds in global banks like Societe Generale (SocGen) have highlighted the repercussions of the lack of governance, internal controls, risk mitigation strategies and accountability in financial institutions.

**1.2** In May 2008, the Federal Reserve Bank helped rescue US investment bank, Bear Stearns, injecting a 30 billion dollar restructuring to avoid collapse. (Bear Stearns has been sold to JP Morgan.) In July, the Federal Reserve Bank and the US Treasury have taken steps to save mortgage giants, Fannie Mae and Freddie Mac, through intervention, as these two key re-packagers of housing loans, had severe liquidity problems. Their combined balance sheets were leveraged 65 times at the end of 2007. Their total liabilities are estimated to be close to 40% of the US GDP. Although they have raised US$ 20 billion by way of new capital in recent months, the recent estimates indicate that their fair value tangible networth is still negative. The bailouts of Fannie Mae and Freddie Mac have raised several key issues: the adequacy of government recapitalization; the timing of government interventions and the impact of such interventions. It is a widely held view that the bailout has not solved the basic issue of insolvency as it has simply transferred risk from the debt holders and counterparties to US tax payers. These two housing banks have been bailed out by giving access to bigger credit lines, although their US$ 5.3 trillion mortgage debt is likely to demand more and more public funds. The recent turmoil was primarily triggered by bad lending for high risk or sub prime mortgages, which were repackaged as securities and sold worldwide to banks, which suffered huge losses after borrowers defaulted on the loans.

**1.3** In the UK, the Bank of England (BOE) was forced to save the mortgage lender, Northern Rock, the first major bank to experience a run in the UK in more than 140 years. The bank was unable to raise cash to meet its obligations due to illiquidity and was given emergency funding and then nationalized by the UK government. While the BOE and the Financial Services Authority (FSA) were struggling in the bail out operations of Northern Rock, inter-bank lending dried up in the wake of the sub prime crisis, as banks became wary of lending to one another, because of their inability to assess how exposed their counterparts might be to losses from the widely-spread financial turmoil.

**1.4** In the meantime, the European Central Bank (ECB), which was initially in the lead, injected 348 billion euros (550 billion dollars) by way of two-week funds to banks to tide over until 2008, to convince banks to continue the provision of credit to markets and businesses. Along with the ECB, since December 2007, coordinated efforts have been made by the Fed, BOE, the Swiss National Bank (SNB) and the Bank of Canada, by providing cash injections, to reduce tension and panic in financial markets and to restore public confidence in financial institutions. These liquidity injections were accompanied by interest rate cuts, in particular by the Fed to its current level of 2 percent since September 2008. During the turmoil, the major central banks also departed from the normal prudent practice of accepting quality collateral from commercial banks. Almost all central banks relaxed their stringent criteria and offered special facilities to banks to enable them to provide credit to a larger number of financial institutions and markets.

**1.5** The woes of Fannie Mae and Freddie Mac, the tumbling stock markets, the forecast decline in world growth from 3.8% in 2007 to around 2.9% in 2008, and the climbing oil prices in a range of US$ 100 - 150 a barrel make clear how far the turmoil is from its end. The volatility in other asset classes has led investors to return to what they consider a haven. Investments in gold have been evident and that has resulted in gold prices reaching a high level of US$ 900 – 1000 and beyond.

**1.6** When the US and global financial market turmoil started to unfold, different views were expressed on the degree of regulation. One school of thought was that regulation is the answer to financial turmoil and more regulations are needed to deal with the situation. The opposing view was that further tightening regulation would be a problem and more of it would only make matters worse. While the debate on the adequate degree and strength of regulation is still on going, it is worth looking at the root causes of recent financial market turmoil to assess the extent to which regulatory lapses or lax regulation were accountable for the turmoil or whether it is mainly the lack of Governance, Risk management and Compliance (GRC) by banks and financial institutions that resulted in financial market turbulence.

**1.7** As in the past, much of the turmoil has been due to lapses in GRC practices. Although Sri Lanka has been insulated from the recent financial market turmoil, these episodes strongly underscore the need for good corporate governance, better risk management and compliance by the financial services industry. There are many lessons to learn from these experiences of others, as Sri Lanka's financial services industry too could be tempted to provide

low quality credit, live with liquidity mismatches, not adhere to regulations or follow transparent processes, which have been the root causes of this turmoil.

## 2. GRC: Key Pillars

**2.1** In this background, it is important to generate a wider discussion on Governance, Risk Management and Compliance – in short – GRC, which are considered to be the three key pillars or imperatives of financial management. By itself, GRC is not new or unknown. GRC has always been of fundamental concern to businesses, the financial services industry and to regulators and supervisors. All stakeholders realize that there are enormous benefits in observing GRC and that such benefits would outweigh the cost of putting in place processes, procedures and controls that enable effective implementation of GRC.

**2.2** **Governance -** The main component of GRC is Governance, which is self-discipline. It is the process by which the Board of Directors sets the objectives for an organization and oversees the progress towards achieving those objectives. Put simply, it is the set of procedures and processes that keeps the organization alive and allows it to operate as a "going concern". The higher the sophistication of the financial system, the higher would be the need for Governance as regulation and supervision cannot cover all risk elements in their supervisory processes. Some of the important aspects of Governance include the following:

- content and clarity of financial institutions' disclosures, as well as the comprehensiveness of coverage;
- risk disclosures that provide the clearest possible picture of the institutions' overall risk profile, as well as salient features of the Risk Management processes;
- global standards and harmonization processes of market definitions and structures; and
- inclusion of the most relevant and material risks or exposures arising under current market conditions at the time the disclosure is made, in addition to off-balance sheet risks or exposures, especially for securitization business.

**2.3** **Risk Management** – This involves identification, assessment, continuous monitoring of risks (real or hypothesized) and risk mitigation, while maximizing returns. In financial business, risk can emanate from many sources. The well-known risks are credit, liquidity, market, operational and human capital risks, although there are several other risks, such as cross-border product risks, capital risk, illiquidity risks etc. The new and highly complex products that are being offered by foreign financial markets or institutions can have cross-border risks, as their distribution can bring in serious contagion risks across global markets. Most financial institutions do not view equity as risk capital. In banking, risks must include situations of drying up of liquidity. A case in point is the Northern Rock episode, in which the bank exposed itself to the illiquidity risk. The need to bring in new capital to cover illiquidity was not given adequate attention by Northern Rock. Such risks should also be analysed by banks and financial institutions and they should be included in their risk management framework. Ignoring risks or not taking action to mitigate them can be construed as "moral hazard", which leads banks and financial institutions to expect

the public to rescue their institutions, and hence continue to run on an illiquid basis, until they face a serious drying up of liquidity. If managed properly, risks can be confined to the institution concerned. If not, any one of these risks or a combination can affect a group of financial institutions or the entire financial services industry, leading to a systemic risk. As Martin Wolf, a well known Financial Times journalist said "The financial services industry is famous for privatizing its gains and socializing its losses, in that it expects the society at large to rescue it through public funds".

**2.4** **Compliance -** This relates to laws and regulations, internal policies and procedures. Literally, Compliance means obedience or dutifulness, but it has broad scope and various interpretations. Compliance generally covers matters such as observance, application of standards of market conduct and managing conflicts of interests. More recently, compliance has expanded its scope to cover specific areas such as operations of money laundering and terrorist financing and even tax laws that are relevant to financial services. In brief, the compliance function should protect the institution against unlawful behaviour and strengthen its ethical consciousness. A Board of Directors of any financial institution should approve and oversee the institution's strategic objectives and set a compliance culture. Similarly, the Board should ensure that the financial institution has adequate policies and procedures that enable oversight functions to be carried out on all business lines. Given their fiduciary responsibilities, financial institutions, in particular, should comply with applicable laws and regulations in the jurisdiction in which they operate.

**2.5** The word 'Compliance' has also a connotation of regulatory and supervisory structures, which means that there is an external regulatory or supervisory body to ensure that financial institutions adhere to norms, guidelines and rules set by it. Compliance is considered to be costly, time consuming and an onerous endeavor. Compliance efforts will be effective and sustainable only in organizations where compliance emerges from an ongoing board level engagement. Compliance management, therefore, is the execution of business processes designed to manage risks and to continuously benchmark against expected parameters/tolerance levels applicable to the entire industry.

**2.6** Many financial institutions understand the criticality and the importance of better GRC and they are willing to devise strategies for leveraging their GRC systems to derive value as well as increase their compliance performance. Behind all these imperatives is the commitment at all levels to manage GRC in an integrated manner and inculcate the culture across the financial services industry.

**2.7** The three GRC imperatives are interrelated in financial business and implementing them in isolation or treating them as separate elements would not be of much use. Most financial institutions have viewed GRC as discrete activities undertaken by different departments with no coordination, which has resulted in lack of integration of GRC across business areas or functions. The emerging perception of GRC is that it is an integrated set of concepts and, when applied holistically within an organization, it can add significant value and provide competitive advantage. Further, the holistic approach would be more efficient, consistent and legally sound and the Boards of Directors, senior management and staff at all levels would be involved in the organization's conduct of business.

## 3. Proposed New Regulations / Guidelines for Integrated Risk Management

**3.1** During the past few years, regulatory and compliance requirements of the financial institutions have strengthened globally. Since the first updating of the Basel Capital Accord in the late 1990s and the Sarbanes-Oxley Act in 2002, the launch of new regulations seems to have become more frequent. With these new requirements, financial institutions are facing an amplified focus on risk management with risk-based performance measures and capital allocation. Rating agencies too have expanded their analysis of Integrated Risk Management practices when determining credit ratings although, in many instances, rating agencies have not lived upto their expectations.

**3.2** The FSA in the UK has published its risk outlook report in 2008, which has identified 5 priority risks. Although some of these may not be directly relevant or applicable to Sri Lanka's financial institutions, they are common risks that need to be flagged by the Boards of Directors of financial institutions. The priority risks set out by the FSA are:

- Market risk: Adverse market conditions and strain on existing business models;
- Liquidity risk: Given the nature of financial business, i.e. borrow short term for funding longer term lending, it is irrational to assume plentiful liquidity to prevail at all times without treating liquidity as part of risk capital;
- Borrowing risk: A significant minority of consumers could experience financial problems due to high borrowings;
- Financial crime risk: Tighter economic conditions could increase the incidence or discovery of financial crime; and
- Loss of confidence risk in financial institutions and the regulatory institutions: Market participants and consumers may lose confidence in financial institutions and in the authority's ability to safeguard the financial system.

**3.3** In addition to these, there could also be institution specific risks, which may bring in potential disturbances. Conventional wisdom is that the more recent episodes like Northern Rock could not have been avoided as banking regulations have not been emphasizing liquidity risks. The recent turmoil has exposed the vulnerability of a regulatory framework that places so much emphasis on how well capitalized a bank is, but makes little reference to whether it has an adequate cash cushion and liquid securities to see the institution through a period of market turbulence. In this instance, the present Basel II regime, with the three key pillars introduced in 2005, also does not seem to offer much help.

## 4. Proposed Revisions to the Basel II Guidelines: March 2008

**4.1** **Market Risk Framework:** The July 2005 Basel Committee Agreement (Basel Committee on Banking Supervision, *the Application of Basel II to Trading Activities and the Treatment of Double Default Effects,* July 2005; and Basel Committee on Banking Supervision, *Guidelines for computing capital for incremental risk in the trading book,* consultative document, July 2008)

proposed several improvements to the capital regime for trading book positions. One of the requirements for banks was to measure and hold capital against default risk. The incremental default risk captured in the bank's value at risk (VAR) model was incorporated into the trading book in response to the increasing exposures in the trading books to credit related and often illiquid product risk, which are not reflected in the VAR models. At its meeting in March 2008, the Basel Committee decided to expand the scope of the capital charge to capture not only defaults, but a wider range of incremental risks, to improve the internal VAR models for market risk, and to update the prudent valuation guidelines for positions subject to market risk of the present Basel II framework. The consultative paper requesting observations for member countries has been released recently.

**4.2** To complement the incremental risk capital framework, the Committee has announced wordings with respect to prudent valuation for positions, subject to market risk more consistent with existing accounting guidelines, and has clarified that regulators will retain the ability to require adjustments to current value beyond those required by financial reporting standards, in particular, where there is uncertainty around the current realizable value of a position due to illiquidity. This guideline focuses on the current valuation of the position and is a separate concern from the risk that market conditions and/or variables will change before the position is liquidated (or closed out), causing a loss of value to positions held. Banks are expected to comply with the revised requirements, in order to receive approval for using internal models for the calculation of market risk capital requirements.

**4.3** For portfolios and products for which a bank has already received approval for using internal models for the calculation of market risk capital and/or specific risk model recognition, it would not have to comply with the revised requirements until 1 January 2010. Subject to supervisory approval, a bank that is unable to calculate an incremental risk charge for default and migration risks of credit positions to the satisfaction of its supervisor, may use a temporary fallback option as described in the Guidelines between 1 January 2010 and 31 December 2010. Furthermore, banks will be allowed one more year (i.e. until 1 January 2011) to incorporate into their incremental risk capital models all risks covered by the incremental risk capital charge beyond those attributable to default and migration risks for positions subject to credit risk.

**4.4** For re-securitisations that are cash or derivative credit positions, banks are subject to a capital requirement as set out in Basel II framework, starting 1 January 2009, until the bank has fully implemented both phases of the incremental risk capital charge for these positions.

**4.5** **Computing Capital for Incremental Risk in the Trading Book:** The Committee expects banks to develop their own models for calculating the Incremental Risk Capital (IRC) for trading book positions.

**4.6** Banks must meet the guidelines for calculating the IRC that are laid out in the consultative document, in order to receive specific risk model recognition. For portfolios or products for which banks have already received specific risk model recognition under the 1996

Market Risk Amendment (MRA), they would not be required to implement the IRC until 1 January 2010. Effective 1 January 2010, a bank's IRC model must incorporate, at a minimum, credit default and migration risks for positions subject to credit risk or subject to supervisory approval, the bank must use the fallback option described below. Banks will be allowed one more year (i.e. until 1 January 2011) to incorporate into their IRC models all remaining price risks for credit positions (i.e. risks that are unrelated to defaults or credit migrations), as well as all price risks for equity positions.

**4.7** The quantitative impact of these guidelines on banks' capital requirements will be evaluated in two stages. In the first stage, the Committee plans to largely rely on the data collected from the previous quantitative impact study in late 2007 to examine the impact of incorporating default and migration risk into the IRC by 2010. In stage two, additional data will be collected to examine the impact of incorporating other risks such as credit spread and equity price risk into the IRC by 2011. The exposure draft with new guidelines is expected to be finalized in the near future with set target dates for implementation. In this context, it is important for banks in Sri Lanka too to understand the need for readiness, even though the deadlines may not be equally applicable to all countries.

## 5. Market Best Practice: The Institute of International Finance Report, July 2008

**5.1** The Institute of International Finance Inc., which has a membership of the world's leading financial services firms, released its Report in July 2008, detailing best practice reforms for the industry. The Report indicated that mortgage brokers were arranging loans, and non-bank originators were often making loans, without applying lending standards. This Report has offered some important and practical strategies on transparency and disclosures and risk management, which are two key components of GRC. International standard setters may consider some of these recommendations seriously when they finalise global standards.

**5.2** The Report stated that "a robust and pervasive risk culture throughout the firm is essential. This risk culture should be embedded in the way the firm operates and should cover all areas and activities, with particular care not to limit risk management to specific business areas or to have it operate only as an audit or control function". Thus, financial institutions are expected to move towards Integrated Risk Management (IRM) which, in simple terms, is a continuous proactive and systematic process aimed at understanding, managing and communicating risks from an organization-wide perspective. It is about making strategic decisions that contribute to the achievement of an organization's overall corporate objectives. In other words, IRM requires an on-going assessment of potential risks at every level and every segment and then aggregating the results at the corporate level to facilitate priority setting and improved decision-making. IRM should be embedded in the organization's corporate strategy and it should shape the organization's risk mitigation culture and highlight the importance of effective coordination among interdependent risks.

**5.3** The Report notes that firms should make clear that senior management, in particular, the CEO and that the Chief Risk Officer (CRO), have the ability to influence key decision-makers in the firm "with the mandate to ascertain that the firm's risk level is consistent with its risk appetite and provide a thoughtful, integrated view of the overall risks the firm faces." The recommendations also note that stress testing should be an integral part of assessing the bank's risk profile in relation to its risk appetite across all business activities, risk types and exposures. The Report also emphasised that firms should ensure that risk management does not rely on a single methodology.

**5.4** The Report underlines that the severity and persistence of the liquidity strains in financial markets after July 2007, particularly at the longer end of the money market, were unprecedented and generally not anticipated. A fundamental problem leading to adverse market conditions was that the market did not recognize how sensitive investors providing market liquidity would be to the issues of asset quality and credibility of ratings for structured vehicles such as conduits or to assurances of short-term access to funds invested in such vehicles, regardless of either the term of investments or the legal structure of transactions. With a particular focus on the US, the report recommends that non-bank institutions involved with originating mortgages should be held to the same standards as banks. "Financial institutions should apply the same credit due diligence for structured products that they plan to originate and distribute as they do for similar assets that are to be carried on the firm's own balance sheet", the report said.

## 6. Changes to the Regulatory Framework in Sri Lanka

**6.1** The objective of prudential supervision is to correct the misalignment between private incentives and public policy goals by forcing banks to deliver higher standards of liquidity and other risk management and to build stronger defences than they would naturally provide of their own volition. Resolving this issue raises major challenges for the global regulatory community, given the strong increase in financial market integration and the significant growth in banks. The domestic supervisors would be required to liaise closely with international committees and regulatory authorities in designing sound practices for the management and supervision of risk in an integrated framework. Accordingly, Sri Lanka too has to keep close liase with the international standard setters and regulatory agencies in other countries to exchange information and adopt international best practice.

**6.2** Much of the sub prime problem was due to bad lending that was preventable by observing normal prudent standards. Regulation comes into picture with respect to the operations of the non-bank financial institutions, which originated due to bad lending. Securitization of mortgages encouraged careless lending because of the ability to blend, disguise and then pass on to others. The rating agencies were expected to highlight the dangers, but they too failed. Similarly, securitization allowed banks to avail themselves of the requirement to reserve capital, enabling them to hide the problem under off-balance sheet items. The spread of securitization, however, demands new liquidity standards and higher capital ratios, which is the regulatory part. Fraudulent activities are largely governance issues and have been due to lack of processes and procedures, and they lie outside regulatory preview.

**6.3** Over the last few years, several new regulatory measures have been introduced to strengthen the regulatory and supervisory framework in Sri Lanka, keeping in line with the Central Bank's move towards risk-focused supervision. In 2002, the Central Bank issued a voluntary code of governance for banks and financial institutions, expecting them to improve their corporate governance. However, the voluntary observance did not show significant improvement, primarily due to lack of commitment by the Boards of Directors. Much of the concern underlying the issue of the code was related to the non-availability of proper GRC processes in financial institutions. Hence, considering the need to promote fiduciary responsibility of the Boards and in the interest of wider financial system stability, the Central Bank issued directions on corporate governance in December 2007, requiring the banks to streamline their governance practices commencing from 2008.

**6.4** The implementation of the Basel II framework from January 2008 is another enhancement to the regulatory structure, which requires the financial services industry to have a better GRC framework. Most of the leading banks have set up independent risk management and compliance divisions to monitor bank-wide risks. These institutions should now focus on moving forward to implement advanced approaches under the Basel II framework by setting up data warehouses, appropriate IT systems and undertaking customer rating to further improve GRC. Similarly, the adoption of International Accounting Standards such as IAS 32 & 39 and IFRS 7, which deal with disclosures, presentation, recognition and measurement of financial instruments, also highlights the need for integrated risk management, disclosures and compliance. Many banks are reluctant to build robust and advanced IT frameworks due to the high cost of investment at the start and possible short-term disruption to operations. It is important that banks and financial institutions change this mindset to pave the way for a GRC management and also to avoid operational losses, due to product failures and frauds. Risks arising in these areas could spread beyond the financial institution concerned, and have the potential to affect the entire industry.

**6.5** It is important for Sri Lanka also to pay attention to the lessons from the recent financial turmoil, although the country is at present insulated from the consequences of the turmoil. By way of learning from the experiences, first, the financial services industry needs to understand the various sources risks, particularly under stressed conditions. Second, the industry needs to develop more effective contingency funding plans to deal with liquidity risk. Third, the industry should provide support to improve market functions and strict discipline through enhanced disclosure. Finally, regulators and supervisors need to ensure that banks and financial institutions work within an integrated risk management, including liquidity risk, and adopt more robust standards to avoid bank failures and their consequences on the wider financial system. The new regulations to be finalized under Basel II amended guidelines appear to require further enhancements to capital to deal with liquidity risks. All these steps are critical to implement GRC.

## 7. Challenges in implementing an Integrated GRC Framework

**7.1** Understanding the demands of the organization's stakeholders is the key in terms of performance and conformance, and aligning the organization to deliver against these

objectives. Considering the risk appetite and risk tolerance of the organization, the processes and technology should be designed and deployed so that the achievement of objectives is measured, risks are assessed and continuous improvement is realized in support of effective GRC. Integrating GRC has become a challenge for virtually every financial institution looking to establish an integrated and consistent approach to controlling exposures, managing risks and creating value.

7.2 **Integration with Existing Solutions:** A major challenge in adopting an integrated GRC approach is the aligning of the GRC framework and processes to standalone and isolated solutions that are already in place. The difficulty is to integrate these isolated solutions through a flexible and add-on basis to embrace new requirements. Changing core business solutions without overhauling business requirements is considered to be a nightmare by many financial institutions. If it is properly planned and designed, however, it would not be that bad, and those who take the bold decision to do so will be tomorrow's winners.

7.3 **Making GRC Internationally Compliant:** This is another challenge as it requires rules, security features, new policies and procedures to be written with links to automated systems. Keeping up with the international best practice is not an easy task, as many of the international standards are set taking into consideration the requirements of G-10 countries, and advanced financial markets. At the designing stage of best practice, the involvement of less-developed and emerging markets has been limited. The Report by the Institute of International Finance proposes principles of conduct, together with best practice recommendations on critical issues such as risk management, compensation policies, valuation of assets, liquidity management, underwriting and the rating of structured products, as well as boosting transparency and disclosure. International compliance will also bring in new challenges for the supervisory and legislative community. The changes that occur at high speed, the new risks and complexities that cut across the financial services industry at an international level may pose difficulties for institutions to be compliant at all times, because today's compliance may not hold for tomorrow. Banks and financial institutions in Sri Lanka should engage in an effective consultative process with the regulators to agree on suitable modifications to some of the best practices announced by the international standard setters.

7.4 **Risks of Innovative Products:** Given the expansion of financial markets associated with rapid growth in India and China, it is essential for banking and financial institutions in the Asian region to analyze risks relating to innovative financial products that will make inroads to Sri Lanka. In this regard, the wider financial system in Sri Lanka should be adequately robust and resilient to deal with complex risks associated with these new products. In this context too, Sri Lanka's financial services industry should focus on GRC as a package and deal with these three pillars or imperatives within an integrated framework.

7.5 **Limited Awareness:** Introducing an "awareness culture" of GRC is another challenge. It is necessary to ensure that the integrated GRC is considered a prime objective of the employees and the Boards of Directors, as well as the senior management of financial institutions. Continuous training of relevant stakeholders would be a solution to this challenge.

## 8. Key Elements of a Roadmap

### 8.1 Firm Commitment to Implement GRC as a Package

- The key to meet GRC challenges is the commitment by all stakeholders, i.e. the Boards of Directors, senior management and employees of the financial institution. The commitment has to be clearly demonstrated at all levels and not by isolated groups within the institution. Usually, commitment should commence at the top and filter down to all levels, which requires a well-coordinated effort.

- **Assessment of Current and Potential Risks:** It would be necessary to survey the existing GRC framework and identify gaps focusing on different procedures and processes that exist in organizations. All stakeholders should be convinced that the key GRC elements point towards the same goal and that there is little use in implementing these critical components in isolation and on a compartmentalized basis. The integrated GRC package should relate to the business model of the financial institutions, while focusing on their fiduciary responsibilities. Each institution should be given a standard format and key components that need to be included in its GRC. Once each financial institution has designed its GRC framework, it would be easy to transform it to a common framework applicable to the entire financial services industry. The possible conduits in Sri Lanka would be the formal and informal institutions with coordination among different segments of the industry. The Sri Lanka Banks' Association, the Professional Bankers' Association, the Finance Houses Association, the Leasing Association and the Primary Dealers' Association etc., should be able to coordinate within their segments and among others in the financial services industry in implementing an integrated GRC framework.

- **Exert Peer Pressure:** If one financial institution experiences problems today, given the interrelated transactions, it could lead to a systemic issue which will result in the entire system suffering, while losing public confidence. Therefore, it is equally important to use peer pressure to get weak or non compliant institutions to comply with regulatory instructions and directives, ensuring that outliers are brought on to the desired path.

- **Training and Consultation:** This component remains very important, especially to change the lackadaisical mindset to a more committed one. All stakeholders need to understand why GRC should be implemented as a package and the benefits attached to it, from the point of view of the institution as well as its clients.

### 8.2 Leveraging on Technology

- **Technology Integration:** Technology is a critical factor, which facilitates efficiency and effectiveness in an integrated GRC framework. A real time risk, compliance and monitoring environment enables financial institutions to ensure that risks are being managed and

disruptive events are being acted upon. Therefore, technology integration across the financial institution would enable institutions to gain more timely and reliable regulatory compliance, more efficient use of IT systems, and lower cost on development and maintenance of software applications.

- **Service-Oriented Architecture:** Many organizations that apply GRC best practices have understood that service-oriented architecture (SOA) is more appropriate, as it would promote GRC integration while securing the highest value that IT can offer. SOA provides IT infrastructure, which allows different applications to exchange databases and participate in business processes that are loosely coupled from the operating systems and programming languages underlying those applications. SOA is a design for linking business and computational resources that are available on demand to achieve the desired results to service consumers. Under SOA models, different applications/services can communicate with each other by passing data from one application/service to another, or by coordinating an activity between two or more applications/services. Further, the financial institutions with IT infrastructure based on stand alone systems acquired over time to meet different business goals can benefit from an integrated SOA. Web services can be considered to implement a SOA, where certain functions/services can be accessible over standard Internet protocols that are independent from other IT systems in the institution. The Central Bank of Sri Lanka is now using a web-based application to gather regulatory compliance reports from financial institutions. Although it is still at a preliminary stage, it is certainly a step towards improving the quality of supervision of the GRC in banks.

## 9. Conclusion

**9.1** Change is inevitable. If the financial services industry is not willing to change, global forces will force change on us. Domestic regulators will have no choice, but to fall in line with international best practice. In this context, countries like Sri Lanka should prepare well in advance and adopt a gradual approach for the implementation of best practice. In doing so, there should be a multifaceted approach to face the GRC challenges. GRC should be treated as one package or a set. This approach includes governance built on principles and rules, integrated risk management mechanisms to identify, assess and mitigate risks and a defined compliance mechanism that deals with internal and external compliance requirements. Financial institutions have the responsibility to establish a compliance mindset throughout the organization as a foundation that places high importance on ethics, trust and values. The energies of all banks and financial institutions should be geared to observance of GRC.

**9.2** The foregoing sections have highlighted the upcoming new additions to regulations / best practice and guidelines by international and domestic standard setters. The challenges that financial institutions could encounter in implementing GRC would be the increasing globalization, continuously changing laws and regulations, various forms of financial stresses and continuous evolution of complex financial products. These challenges underscore the importance

of compliance and best practice, which have already been set by the financial services industry regulators and supervisors, as well as the international standard setters.

**9.3** In the present turbulent financial environment, where the stakeholders and other interested parties put pressure for greater transparency and corporate responsibility, the Boards of Directors and senior management have to set high standards in adopting GRC. The increase in investments to improve the IT infrastructure and human resources to integrate GRC management can improve risk management as well as compliance performance and its efficiencies. Financial institutions that have strong governance and compliance processes in an integrated GRC framework will be more capable of winning public confidence, attracting investors and improving corporate reputation and efficiency, as well as contributing to promote financial system stability.

**9.4** Northern Rock's fall has become an important episode for the times: a story of insecurity, mistrust and powerlessness that often seem to best describe some financial markets in our part of the world as well. It speaks of the fragility of the international financial system, which is directly impacted by globalization, of the capacity of the regulatory institutions and governments to shape events and the powerlessness of all stakeholders to halt an erosion of confidence, if a systemically important institution were to become insolvent.

**9.5** Markets and investors are much more vigilant on banks and financial institutions. They may watch global events with amusement or with justified suspicion and feel that nothing is straightforward anymore. Banks and financial institutions have a responsibility to reduce such feelings in the public and instill confidence in them. Given the severe impacts of the recent turmoil, it is important that the financial services industry, as well as the regulatory bodies, reflect on what additional precautionary efforts should be initiated to ensure that Sri Lanka's financial services industry continues to function as a stable and resilient one. This does not mean that the financial services industry should be over-regulated. Nevertheless, working within a comprehensive GRC would be the key to ensure system-wide stability in turbulent times .