SLOVENIA

Assistance to the Bank of Slovenia for the Development and Implementation of Risk Appetite Guidelines for Banks

Technical Assistance Project

Terms of Reference

1. BACKGROUND

1. Interplay between corporate governance and risk appetite framework

Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. Banks perform a key role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth, and therefore the safety and soundness of their operations is an issue of critical importance to the broader health of an economy. In the aftermath of the global financial crisis, poor risk assessment, weaknesses in corporate governance and lax underwriting standards were highlighted as key issues that have contributed to imprudent risk-taking in the banking sector, which has in turn led to concerns for the stability of individual credit institutions and the financial system as a whole. These weaknesses were particularly visible in Slovenia and the banking crisis has highlighted the need for greater supervisory powers of the Bank of Slovenia, as well as the enhancement of risk management practices in Slovenian banks and stricter adherence to regulations and guidance issued by the supervisor.

A bank’s governance and risk management have a significant impact on its overall risk profile and sustainability of its business model. This importance tends to become especially evident in times of economic, financial and regulatory uncertainty. A fundamental principle underpinning corporate governance is that the board - which is in charge of overseeing risk management and internal control functions in a bank - must understand the risks to which the bank is exposed in its operations. Therefore, the Corporate Governance Principles for Banks issued by the Basel Committee provide that establishing the bank’s corporate culture and risk appetite is a key function of the board that should enable it to oversee the bank’s governance framework and ensure that it remains appropriate in the light of material changes to the bank’s operations and environment. To that end, a sound risk appetite framework

1 See EBRD Strategy for Slovenia, as approved by the Board of Directors on 26 February, 2014, at 38.
4 The Financial Stability Board (FSB) defines risk appetite framework as “the overall approach, including policies, processes, controls, and systems through which risk appetite is established, communicated, and monitored”. It includes a risk statement, risk limits, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the risk appetite framework (see FSB: Principles for an Effective Risk Appetite Framework (2013), available at: http://www.fsb.org/wp-content/uploads/r_131118.pdf).
should be established in order to enable a more holistic and thorough understanding of the risks inherent to a particular institution. Specifically, the risk appetite framework:

- demonstrates the implicit link between risk appetite and strategy;
- defines risk limits and tolerances around those limits;
- clarifies the action required in the event of a breach of risk limits; and
- specifies the roles and responsibilities of the officers that are responsible for the framework’s implementation.

Supervisors play a crucial role in assessing the adequacy of a bank’s risk governance framework and should be able to examine the risk appetite frameworks using a variety of tools (e.g., on-site inspections, off-site reviews and SREP dialogue, horizontal reviews, etc.). Also, supervisors should have numerous mechanisms to incentivise banks to remedy deficiencies within their risk governance framework such as, imposition of capital surcharges, fines and penalties; restrictions on certain business activities, etc.

Supervisory expectations for risk governance practices are generally set out within the legal framework through a combination of legislation, regulation and supervisory guidance. With the implementation of Directive 2013/36/EU and Regulation (EU) No 575/2013 (the so-called CRD IV package), which transpose the new global standards on bank capital and liquidity (the so-called Basel III Agreement) into the EU law, and the establishment of the Single Supervisory Mechanism led by the European Central Bank, development of effective risk appetite frameworks is becoming increasingly significant as an area of supervisory interest. The CRD IV package explicitly links a number of very important areas of corporate governance to a bank’s risk appetite (remuneration policies, board reports and risk management processes, disclosure, etc.).

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6 SREP stands for Supervisory Review and Evaluation Process. Specifically, the SREP shows where a bank stands in terms of capital requirements and the way it deals with risks. In the SREP decision, which the supervisor sends to the bank at the end of the process, key objectives are set to address the identified issues. The bank must then “correct” these within a specific time.


9 Recital 63 of the CRD IV states that remuneration policies should be aligned with the risk appetite, values and long-term interests of the credit institution.

10 Article 76 of the CRD IV tasks the risk committee with advising the board on the bank’s overall current and future risk appetite and strategy and assisting it in overseeing the implementation. To that end, members of that
2. **Bank of Slovenia**

The Bank of Slovenia is in charge of implementing CRD IV, as transposed within the Slovenian legal framework, and is a participant in the Single Supervisory Mechanism. The Bank of Slovenia’s regulation also contains a definition of risk appetite and the contents of the bank’s risk appetite statement, but it does not regulate in detail the procedural and corporate governance aspects pertinent to the development and effective implementation of a risk appetite framework.

Even though the Slovenian banking sector has largely recovered from the crisis of 2011-2013 in terms of capital adequacy, further attention is warranted with regards to improving risk management practices, as failure to adjust business models in conditions of persistently low profitability and interest rates may leave banks vulnerable in future stress events. In light of pressures to profitability and increased cross border competition, the European Commission and the European Council perceive further resolution of non-performing loans and the management of credit risk as key policy priorities in the short term and the IMF recommends that Slovenian banks proactively and substantially reconsider their cost structures and revenue sources, while at the same time maintaining adequate lending standards to avoid a resurgence of NPLs. Therefore, the link between governance and risk management, on the one hand, and efficiency and soundness of operations, on the other hand, should be strengthened, which highlights a need for the development of robust risk appetite frameworks.

3. **LTT and Bank of Slovenia**

Since 2014, LTT has been working with the Bank of Slovenia on the alignment of the Bank of Slovenia’s supervisory practices with those of the EU (especially the ECB SSM Supervisory Manual), with specific regard to the assessment of the suitability of the members of the management body (both in its management and supervisory functions) and key function holders and the soundness of the internal control framework in banks. This work has

committee should have appropriate knowledge, skills and expertise to fully understand and monitor the risk strategy and the risk appetite of the institution

11 Article 435(1)(f) of Capital Requirements Regulation requires banks to disclose a concise risk statement approved by the management body succinctly describing the institution’s overall risk profile associated with the business strategy.


16 The term “management body”, as defined in Article 3 Paragraph 1 Point (7) of the Directive 2013/36/EU, is used to include all company bodies, as envisaged in the national law, that have executive and/or supervisory functions. Therefore, this term does not make a distinction between one-tier and two-tier board structures.
now been successfully completed and a new supervisory manual was adopted by the Bank of Slovenia in 2015.

In March 2015, the Bank of Slovenia issued the “Report of the Bank of Slovenia on the causes of the capital shortfalls of banks”\(^{17}\) and submitted it to the Slovenian Parliament. The Report endorses LTT’s recommendations on board independence and composition of the audit committee,\(^{18}\) which were then adopted in the new Banking Law, which was approved on 31 March 2015 and entered into force on 13 May 2015.

In October 2015, the Governor of the Bank of Slovenia sent a letter to the EBRD President congratulating EBRD for the excellent work undertaken by LTT. The Governor requested EBRD to continue working with the Bank of Slovenia in strengthening the regulation on risk appetite and the capacity of banks to implement it.

In early 2016, the Bank of Slovenia approached the European Commission requesting financing for the Project, to be implemented under the leadership of the EBRD. The European Commission agreed to finance the Project.

2. **PROJECT OBJECTIVE**

This project (the “Project”) is to assist the Bank of Slovenia in its efforts to strengthen risk management and corporate governance of banks in Slovenia by providing technical assistance in order to develop and put in place guidelines for developing effective risk appetite frameworks - to be incorporated in Slovenian banks’ methodologies, procedures and internal processes, as well as to review the current supervisory practices of the Bank of Slovenia when assessing the risk appetite frameworks of banks and to assist the Bank of Slovenia in developing a new approach for assessing adequacy of risk appetite frameworks, in accordance with the supervisory practices of the ECB’s Single Supervisory Mechanism.

In order to achieve the objective of the Project, a firm or consortium of firms with a team comprising two senior international experts with extensive experience in risk management and corporate governance of credit institutions in the EU (the “Consultants”) will be retained.

3. **SCOPE OF WORK**

The Consultants shall undertake the following activities:

3.1. The Consultants shall, with the assistance of EBRD and the Bank of Slovenia:

a. review the Bank of Slovenia’s methodologies, procedures and processes with particular reference to the assessment of risk appetite frameworks of banks; and

b. review the practices of Slovenian banks regarding development and implementation of risk appetite frameworks, including their ability to assess the actual risk profile, the adequacy of risk appetite statements and risk limits and the integration of risk appetite framework in strategic decision-making processes throughout the bank. The sample of banks for this review shall consist of at least six banks, two of which shall be banks owned by the Republic of Slovenia, two banks which are subsidiaries of banking groups established in the Eurozone, and two banks owned by other private sector entities. This

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information for this review shall be provided by the Bank of Slovenia on an anonymised basis, so to prevent the identification of individual banks. The review may also include meeting with other banks and the Slovenian banks’ association.

3.2. Draft a report (the “Report”) drawing from the above reviews, which will describe (a) best supervisory practices related to assessing risk appetite frameworks for banks in the EU countries with a similar legal and regulatory framework to that of Slovenia and (b) best risk appetite practices in the selected EU credit institutions. The Report shall articulate key actions considered necessary and recommend them for the Bank of Slovenia’s consideration, by addressing, among others, the following issues:

a. internal processes for preparing the Risk Appetite Statement pursuant to Article 435(1)(f) of Regulation (EU) No 575/2013 and the practical application of that statement in the institution's operations;

b. elements of the Risk Appetite Statement (identification of material risks and maximum levels of risk, quantitative measures that can be translated into risk limits applicable to business lines and legal entities, qualitative statements that articulate clearly the motivations for taking on or avoiding certain types of risk, forward looking elements), including the examples of risk appetite statements aligned with best EU practices that can be used as a reference by Slovenian banks;

c. links between the institution's overall risk profile with bank’s business strategy and business goals considered when establishing a risk appetite framework;

d. comprehensiveness of the risk appetite framework in terms of coverage of all material risks, consistency with business and risk strategies, implementation of the bank’s risk limit system in line with the risk bearing capacity, integration in the internal reporting processes and in the remuneration framework;

e. the role of the board and senior management in approving and regularly reviewing and monitoring the actual risk profile (including scope of identified risks) and risk limits against the agreed levels (e.g., by business line, legal entity, product, risk category), and in establishing views on business lines considered to pose the greatest challenges in the management of risk;

f. structures needed to ensure strong accountability and translation of the risk appetite framework into clear incentives and constraints for business lines;

g. group perspective of implementation of the risk appetite frameworks and coverage of activities and operations that fall outside of the control of the bank (e.g. outsourcing);

h. clarity and scope of risk limits used in risk appetite frameworks, coverage across lines and entities, escalation procedures;

i. adaptability of risk appetite framework to changing business and market conditions and the internal processes involved in making decisions on changing risk limits;

j. mechanisms required for ensuring that the risk appetite, risk management strategy, and business strategy are effectively aligned and embedded in decision-making and operations at all appropriate levels of the bank;
k. communication of the risk appetite framework across and within the bank as well as sharing non-confidential information to relevant stakeholders;

l. governance issues related with taking into account risk appetite in daily decision-making (internal processes and controls involved in the risk appetite framework, role of the risk management and internal audit functions, bottom-up and top-down approach in establishing the risk culture of the bank); and

m. approaches taken by supervisors in the EU to assess the risk appetite frameworks and issues mentioned above (off-site reviews, on-site inspections, discussions with the board, senior management and staff, capital add-ons, remedial actions etc.).

3.3. Present the Report to the Bank of Slovenia and, to the extent necessary, revise it based on the comments by the Bank of Slovenia, the European Commission, competent Directorate General and Joint Supervisory Team of the European Central Bank and EBRD.

3.4. Provide the Bank of Slovenia staff with an insight into the best practices in the EU (most notably from countries with a similar regulatory framework or banking sector to that of Slovenia, e.g. Austria, Italy and the Czech Republic) in developing and implementing risk appetite frameworks and preparing risk appetite statements. To this end, the Consultants shall organise a study visit at a selected supervisory authority - to be agreed with the EBRD - which has a proven track record of implementing effective methodologies for assessing banks’ risk appetite frameworks. The study visit shall be organised for up to three members of the Bank of Slovenia staff, and its duration shall be no more than three working days. The study visit materials shall include feedback forms in order to gauge whether knowledge of the participants has been upgraded.

3.5. Based on the final Report, draft Guidelines on risk appetite practices for banks (the “Guidelines”), and advise the Bank of Slovenia on its approach to monitoring their implementation and assessing and scrutinising risk appetite practices in the context of ongoing supervision and the supervisory dialogue.

3.6. Provide training to the Bank of Slovenia to illustrate how to effectively supervise the implementation of the Guidelines (one seminar intended for the Bank of Slovenia supervisory staff) and to Slovenian banks on how they should implement them (two seminars in total, one for bank board representatives and senior management, and one for expert level staff). The training materials shall include training feedback forms in order to gauge whether knowledge of the training participants has been upgraded.

3.7. In addition to the above, the Consultants shall also remain available to provide ad hoc advice to the Bank of Slovenia for the adoption and implementation of the Guidelines up to a maximum of 5 man days during the first 6 months of the implementation.
4. IMPLEMENTATION AND DELIVERABLES

4.1. Implementation

a. The Bank of Slovenia shall evaluate the recommendations presented by the Consultants in the Report, and decide on the solution to be adopted by the Bank of Slovenia. Upon instructions by the Bank of Slovenia, the EBRD Operation Leader (the “OL”) shall instruct the Consultants to:

(i) first, develop and present to the Bank of Slovenia the Guidelines - in line with best practices and the EU law – which will contain recommendations for banks on how to develop and implement appropriate and effective risk appetite frameworks; and

(ii) assist the Bank of Slovenia in monitoring the implementation of the risk appetite frameworks by the banks.

b. The Bank of Slovenia shall commit to providing all necessary equipment, its experts and any documents, data and information necessary for the implementation of the Project. The Bank of Slovenia shall also commit to cover the expenses of travel for the study visit participants, which shall be limited to economy class tickets.

c. The European Commission and the European Central Bank (competent Directorate General and Joint Supervisory Team) shall have access to the Report and the progress reports referred to in Section 5 below and will be invited to provide comments. The Bank of Slovenia shall commit to allowing access to mentioned documents to the European Commission and the European Central Bank.

d. The Consultants will be required to sign a confidentiality agreement with the Bank of Slovenia for the information obtained during the Project.

e. The Project shall be managed by the Operation Leader of the EBRD in consultation with the Bank of Slovenia. The Consultants shall report to and work under the guidance of the Bank of Slovenia and the Operation Leader.

f. The Report and the Guidelines shall be prepared in English. The training shall be delivered in English.

4.2. Deliverables

The Consultants shall deliver the activities described in Section 3 hereof, in particular:

a. Advise the Bank of Slovenia on the specific risk appetite issues and the related supervisory approach, as well as practices in place by the selected EU credit institutions, pursuant to sections 3.1., 3.2. and 3.4. above. The Report shall include all findings - with clear indication of the weaknesses and risks found and relevant recommendations, benchmarked against best EU practices relevant to section 3.3. above.

b. Organisation and implementation of a study visit pursuant to Section 3.4. above. The Consultant shall present a preliminary plan of the study visit at the Project’s inception.
c. Development of the Guidelines and assistance in their implementation, pursuant to section 3.5. above.

d. Development, organisation and implementation of training programs, pursuant to section 3.6. above.

e. Remain available to provide ad hoc advice, pursuant to section 3.7. above.

5. **PROGRESS REPORTING**

Consultants shall deliver to EBRD quarterly reports on the progress of the Project, highlighting major obstacles faced and results achieved.

At the end of the Project, Consultants shall deliver to EBRD a final report, highlighting the major obstacles faced and the results achieved.