# How much risk governance can be found in the risk reporting, disclosure reporting and non-financial reporting of credit institutions?

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**Risk Governance and Sustainability**

# Structure of the presentation

1. **Characterization of Risk Governance and risk management in the context of external reporting**

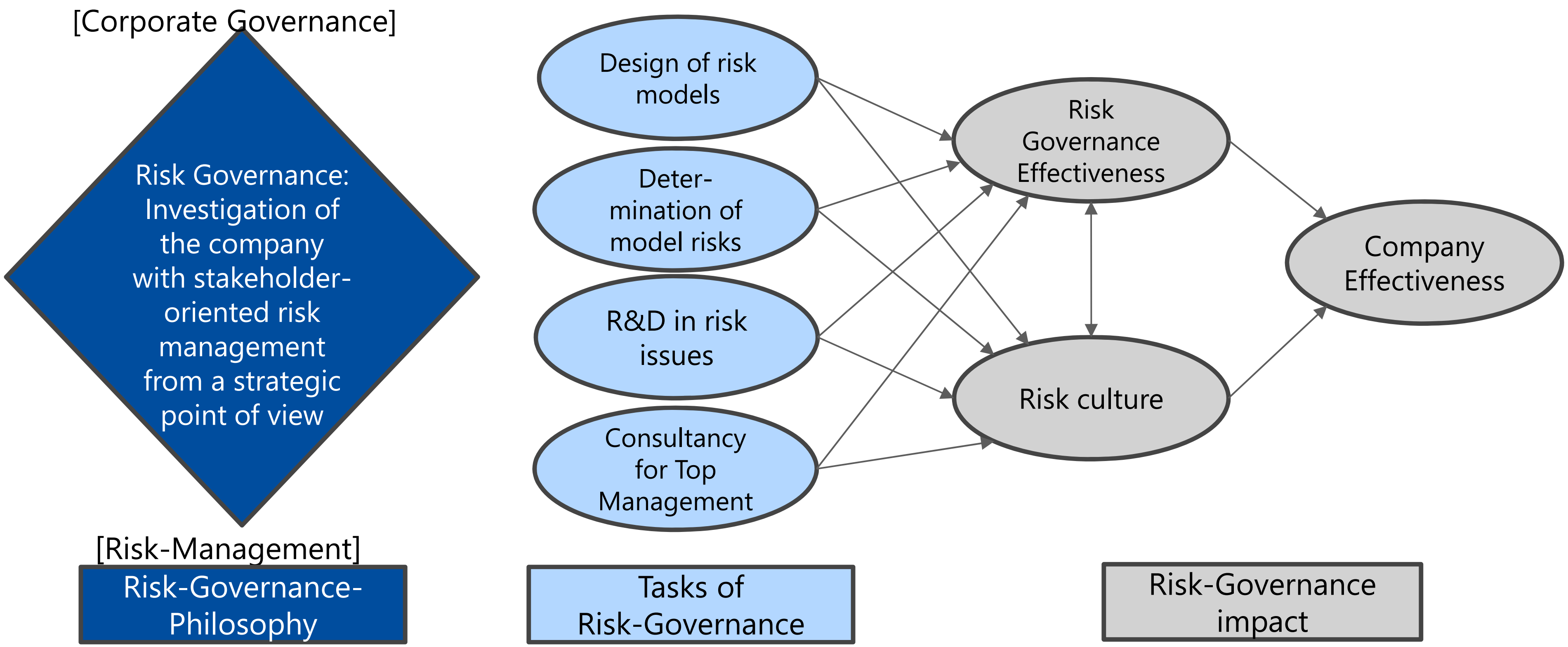
2. Results of the empirical analysis

3. Critical evaluation of the results and areas for “more” Risk Governance

# Definition of Risk Governance in the context of the study

Why is Risk Governance relevant?

- Risk governance makes a contribution to sustainability and thus to save the internal capital adequancy, risk bearing capacity of the credit institution.
- Risk governance can strengthen repuation towards external stakeholders with the help of external reporting.




Quellen: Stein, V./Wiedemann, A. (2016) and Stein, V./Wiedemann, A. (2017)

# Requirements of risk reporting in the risk and disclosure report (I)

- According to the HGB, the expected business development with its significant opportunities and risks must be assessed and explained with regard to risk reporting.
- Specification in non-binding GAS 20:

| Characteristics of the risk management system by GAS 20 |
|---|
| **Objectives & strategy of the risk management:**<br>• Addressing the objectives of the risk management<br>• Addressing the strategy of the risk management<br>• Presenation of the uncaptured and avoided risks<br>• Addressing the principles, behaviour rules, guidelines of risk management and risk bearing capacity |
| **Structure of the risk management**<br>• Providing of a generally accepted framework<br>• Addressing the alignment of the risk management system with the legal and economic structure of the corporation |
| **Process of the risk management**<br>• Discussing the identification, assessment, management and control of risks<br>• Discussing the internal monitoring of these processes |
| **Specifics of risk management systems in instituions**<br>• Addressing the process of allocating risk capital<br>• Addressing monitoring- and reporting systems<br>• Addressing the protection of the management and monitoring systems function |

# Requirements of risk reporting in the risk and disclosure report (II)

Some characteristics in the context of Risk Governance

- In accordance with GAS 20 risks can arise from the company's enviremoment (external risks) as well as from the company itself (internal risks) → Stakeholder view.
- GAS 20 requires that all risks associated with the company's business activities and specific circumstances and affecting the decision-making behaviour of the addressees must be reported.
- Goal is the improvement of the basis for decision-making to ensure the company's long-term success.
- Forecast period of at least three years, significant changes in risk management systems compared with the previous year must be reported.
- GAS 20 provides that the individual risks are merged to one overall risk. Diversification effects may be taken into account in this summary.

# Requirements of risk reporting in the risk and disclosure report (III)

| | | | | |
|---|---|---|---|---|
| Risk management objectives & policies<br>Art. 435 CRR | Credit risk adjustments, Credit risk mitigation techniques<br>Art. 442, 453 CRR | Exposure to securitisation positions<br>Art. 449 CRR | Market, interest rate, operational & equity risk<br>Art. 445-448 CRR | Counterparty credit risk<br>Art. 439 CRR |

Article 435 of the CRR is of particular importance for the basic principles of risk management, objectives and strategy in context with Risk Governance.

| | |
|---|---|
| Art. 435 1a CRR | Strategies and processes to manage those risks |
| Art. 435 1b CRR | Structure and organisation of the relevant risk management function |
| Art. 435 1c CRR | Scope and nature of risk reporting and measurement systems |
| Art. 435 1d CRR | Policies for hedging and mitigating risk, and the strategies and processes for monitoring the continuing effectiveness of hedges and mitigants |
| Art. 435 1e CRR | A declaration approved by the management body on the adequacy of risk management arrangements of the institution providing assurance that the risk management systems put in place are adequate with regard to the institution's profile and strategy |
| Art. 435 1f CRR | A concise risk statement approved by the management body succinctly describing the institution's overall risk profile associated with the business strategy. This statement shall include key ratios and figures providing external stakeholders with a comprehensive view of the institution's management of risk, including how the risk profile of the institution interacts with the risk tolerance set by the management body |

Similarities to risk reporting GAS 20

# Requirements of risk reporting in the non-financial report

- The obligation to prepare a non-financial report is derived from the German CSR Directive Implementation Act (CSR-RUG). Pursuant to Section 289b (1) of the HGB, companies must in principle extend their management report by a non-financial statement if the corporation fulfils the requirements of § 267 (3) HGB sentence 1, is oriented towards the capital market within the meaning of § 264d HGB and has more than 500 employees on annual average.
- In addition, companies can, of course, also voluntarily write a non-financial report.
- National, European or international frameworks may be used to prepare the non-financial report (§ 289d HGB). In Germany, the criteria of the Sustainability Code (DNK) are very often used. However, the aspects according to the CSR-RUG are legally binding.

| CSR-RUG matters (§ 289c HGB) | | Sustainability Code Criteria |
|---|---|---|
| Environmental matters | → | Resource Management |
| Employee-related matters | → | Employee Rights |
| Social matters | → | Corporate Citizenship |
| Respect for human rights | → | Human Rights |
| Anti-corruption and bribery matters | → | Conduct that Complies with the Law and Policy |
| | | Climate-Relevant Emissions |
| | | Equal Opportunities |
| | | … |

# Requirements of risk reporting in the non-financial report

- Risks and their management shall be reported which are very likely to have a negative impact on the aspects mentioned above on the slide and are associated with:
  - The business activities
  - The business relations or
  - The products and services of the company.
- Consequently, risks should be reported which **arise from the respective company** and not or only indirectly from risks to which the company is exposed.
- In order to consider aspects beyond the reporting requirement, the sustainability reports (if available) of the respective institutions were also examined in addition to the non-financial reports.

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# Data sample and Methodology

- A total of 75 reports from 25 banks were evaluated. For another 20 credit institutions, only the risk and disclosure report was evaluated, because non-financial reports did not exist.
- The sample is composed of cooperative banks, saving banks, two major banks and three credit institutions that are classified as sustainable. It represents institutions with different business models and different sizes (balance sheet total between around EUR 2.6 billion and around EUR 1,400 billion).
- The reports are evaluated methodically with the help of qualitative content analysis. For each report, an individual coding guideline is created, on the basis of which the data sample is evaluated and it is checked whether the requirements of the legislator are qualitatively fulfilled.
- Before the coding of the reports, a so-called anchor example is first selected and discussed for each subcode (cf. Mayering/Fenzel, 2019). It is intended to ensure that a systematic and comprehensible evaluation of the reports is carried out.

# Risk Governance in the risk report? (I)

- The code system contains the requirements according to GAS 20 and CRR. In particular, the statements on risk management refer institutions from one reporting format to another.

| Objectives & strategy of the risk management | Structure of the risk management | Process of the risk management |
|---|---|---|

- The reports on the **objectives of risk management** are global and not very institution-specific.
- Not all banks report on the actual **strategy**. A detailed discussion is not recognizable.
- Exemplary from the risk report of a cooperative bank:

  *The defined, sustainable business and risk strategy shapes the concrete structure of the risk management system. The Bank's corporate objectives and planned measures to secure the long-term success of the company are set out in the business strategy approved by the Board of Managing Directors.*

- Some banks refer to risk management guidelines, others also name them explicitly, whereby a strong orientation or exact reproduction of the MaRisk requirements can be seen.

# Risk Governance in the risk report? (II)

- Only a few credit institutions report in more detail about the **structures and organization** and in particular the tasks of the risk controlling function.
- For example, a savings bank names the tasks concretely from its point of view, but essentially adopts the formulations of MaRisk (excerpts here):

> - *Support the management board in all risk policy issues, in particular in developing and implementing the risk strategy and evolving a risk limitation system*
> - *Develop and improve a system of risk ratios and a procedure for the early detection of risks*
> - *Monitor the institution's risk situation and internal capital adequacy as well as compliance with the risk limits in place on an ongoing basis*

- In the **risk management process**, in the key step of risk identification, which ensures long-term early identification of risks, either the risk inventory is referred to as the method of identification in a standardised manner only, or this process step is not mentioned at all.

# Risk Governance in the disclosure report?

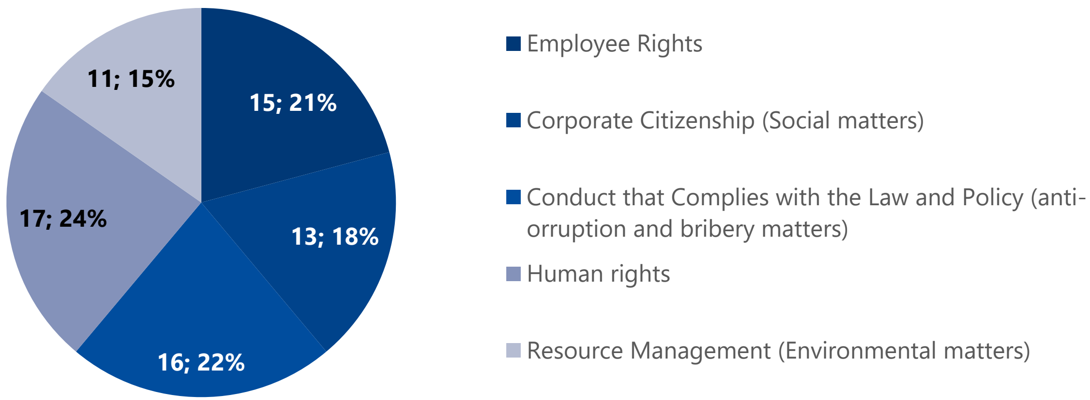
- High redundancy of the risk report with regard to qualitative statements can be identified
- Overall, the disclosure reports on the requirements of Art. 435 CRR are very uniform.
- For example, 80% of cooperative banks report on the risk management guidelines in the disclosure report in almost identical form:

> - Avoid transactions whose risks are unacceptable in view of the institutions risk-bearing capacity and risk strategy.
> - Systematic taking of business positions in which earnings opportunities and risks are in reasonable proportion to each other.
> - Avoid risk concentrations other than those deliberately tolerated, which result from the regional principle.
> - Damage limitation through active management of operational risks.
> - Acceptance of collateral to hedge credit risks

- The disclosure reports of the savings banks do not contain any guidelines comparable to those of the cooperative banks. If guidelines have been formulated, they are an integral part of the risk report. However, the savings banks point out that risks are taken "if opportunities and risks are in an appropriate proportion". This is done in accordance with business policy and business management guidelines and taking into account the risk-bearing capacity of the institution.

# Risk Governance in the non-financial report? (I)

- The majority of credit institutions prepare the non-financial report using the DNK framework.
- Classified according to CSR-RUG criteria, the recording of risks of savings banks and cooperative banks have the following distribution:




- Overall, the institutes most frequently report on the criteria of human rights and conduct in compliance with the law and guidelines in connection with risks.
- However, some non-financial reports do not report at all on risks within the matters of the CSR-RUG.

# Risk Governance in the non-financial report? (II)

Overall, however, no significant risks were identified by any of the banks surveyed.

The two major banks do not differentiate between the risks arising from the aspects mentioned in the law:

The statement by Deutsche Bank is exemplary:

*„In accordance with §§ 315c in connection with 289c (3) no. 3 and 4 HGB, Deutsche Bank evaluates all potential significant environmental, social, and governance (ESG) risks of these topics in connection with its own business activities and business relations, as well as its products and services that are very likely and have or will have a severely negative impact on material non-financial topics. No such risks were identified."*

As can be seen from the previous slide, the cooperative banks and savings banks often go through the individual sustainability criteria. With regard to risk governance, the Sparkasse Hannover, for example, attracted positive attention, combining the expectations of stakeholders with opportunities and risks and thus showing a stakeholder-oriented perspective:

*„The diverse expectations of our stakeholders and the impulses that can be derived from them represent valuable suggestions that support us in continuously improving our sustainability management, exploiting opportunities and avoiding risks."*

In summary, the approach adopted by credit institutions in dealing with the CSR-RUG principles appears to be very standardized.

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# Areas of Risk Governance in the risk- and disclosure report

- Risk governance tasks can be derived from GRS 20 to some extent, as shown in Chapter 1. In particular, however, the concept of risk strategy could be more clearly defined.
- Standards could require more explicit verification of whether all possible types of risk have been identified and verified.
- The fact that GRS 20 is voluntary leads to heterogeneous reporting. Some credit institutions report in great detail, others very briefly. For the data sample, the savings banks and cooperative banks reported between 19 pages and 2.75 pages.
- In the Disclosure Reports, elements of risk governance can be found primarily in Article 435 CRR. However, the focus of the legislator is on a more operational perspective of risk management. Due to the legal obligation, the information in the disclosure report is more homogeneous and less individual.

# Areas of Risk Governance in the risk- and disclosure report

- Overall, the reports of the institutions do not give the impression that the integration of a changing business model is proactively incorporated into the risk assessment.
- To strengthen the content elements of risk governance, both the requirements for risk reporting and the disclosure report could be extended to require the impact of risks on specific stakeholder groups.
- For example, the following questions could be asked in the risk and disclosure reports for the increasingly important risk factor sustainability:
  - Due to the greater sustainability awareness of the stakeholders and the physical/transitory risks, has the adaptation of the business model or the consequences for the risk strategy been considered if the current business model is continued?
  - How can it be ensured that sufficient and appropriate human and other resources are available to meet the new challenges in dealing with sustainability risks?
  - What adverse effects will arise on binding key figures (e.g. capital ratios) if ( main ) sustainability risks materialize?

# Areas of Risk Governance in the non-financial report

- A stakeholder-oriented perspective to be adopted in accordance with Risk Governance arises from the mandatory CSR-RUG aspects. This promotes responsible corporate management and goes beyond standardized operational risk management.
- In addition, the CSR-RUG requires companies to explicitly question their own business activities, business relationships and their products and services from a risk-oriented perspective.
- The non-financial reports of the two major banks deal with the risks arising from their business activities, their business relations or their products and services only in little detail.
- Although the savings banks and cooperative banks base their risk reporting more closely on the individual criteria of the CSR-RUG and the DNK, there is no really differentiated approach.
- Established Risk Governance in the institutions could lead to a stronger debate on these issues and strengthen the reputation towards external stakeholders with the help of external reporting.

**To sum up:** When focusing the company on greater sustainability, not only individual risk areas must be considered, but also the interaction of risks, to which risk governance can make an important contribution.