What's next for bank board risk governance?

Recalibrating to tackle new risk oversight expectations

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We are pleased to share key insights from the Deloitte Center for Financial Services (DCFS)'s fourth-in-a-series study on board risk governance. In this edition, we focused on how bank board risk committees are documenting their risk management governance[1] mandates in light of their evolving roles in managing information flow, holding senior management accountable, and ensuring that the risk management function maintains sufficient independence, among other key priorities.

1. To view the full 22-page report, please visit our Deloitte Insights page at dupress.deloitte.com/dup-us-en/industry/financial-services/bank-board-risk-governance-study.html

Ironically, the demand for more rigorous risk management protocols has emerged at a time when the pace at which new regulations are produced has slowed after a decade of continuous escalation, and when most banks appear to have mastered the large, post-crisis regulatory compliance items such as the US Federal Reserve (the Fed) Comprehensive Capital Analysis and Review process[2].

In August 2017, the Fed proposed revisiting supervisory expectations of bank boards "to establish principles regarding effective boards of directors focused on the performance of a board's core responsibilities." The Fed's proposal delineates board member oversight responsibilities and management's obligations in new board effectiveness (BE) guidance, and follows the US Department of the Treasury's June 2017 recommendation of an interagency review of requirements imposed on banks' boards[3].

In this context, the DCFS study is a timely addition to the current discussion around the role of boards at large banks. The renewed focus on the role of the board risk committee comes at a time when board members frequently find themselves being drawn "into the weeds" of risk management issues, and left with inadequate time to guide and challenge management on broader strategic issues.

A sea change beckons

Since late 2014, when we last analyzed banks' board risk committee charters, many institutions have substantially expanded their compliance documentation procedures in response to expectations from the Federal Reserve's Enhanced Prudential Standards (EPS), the Office of the Comptroller of the Currency's (OCC) Heightened Standards, and the Basel Committee for Banking Supervision's (BCBS) guidelines on bank corporate governance.

However, despite significant progress, our analysis demonstrates that there is clearly much work to be done. Given a more complex and interconnected operating environment, boards must evaluate the interplay of risks resulting from the management's business strategies in order to probe risks to the bank management's business strategies.

Essentially, our study entails analyzing board risk committee charters. While these charters are a useful yardstick to measure the level and quality of risk management oversight of a board's risk committee, we acknowledge their limitations. That said, we see great value in our methodology as transparent, public, and comprehensive documentation is an essential first step to a board risk committee demonstrating its oversight accountability and intent.

An effective board assesses whether the firm's significant **policies, programs, and plans** are consistent with the firm's **strategy, risk tolerance, and risk management capacity.**

2. "Federal Reserve releases results of Comprehensive Capital Analysis and Review (CCAR)," Board of Governors of the Federal Reserve System, 28 June 2017.
3. US Department of the Treasury, "A financial system that creates economic opportunities: Banks and credit unions," June 2017.

Analysis of 2016–2017 charters, and comparison to progress made since late 2014

Because the Fed's August 2017 proposal for Board Effectiveness (BE) guidance coincided with our study, we decided to frame our results in relation to the five clear supervisory expectations that the proposal outlines[4].

01. Setting risk policies, overseeing the risk management and governance framework, and risk strategy and tolerance

The Fed's first supervisory expectation outlines that "...the firm's strategy should clearly articulate objectives consistent with the firm's risk tolerance, and the risk tolerance should clearly specify the aggregate level and types of risks the board is willing to assume to achieve the firm's strategic objectives."[5] In terms of overseeing a firm's risk management framework, the Fed stipulates that "An effective board assesses whether the firm's significant policies, programs, and plans are consistent with the firm's strategy, risk tolerance, and risk management capacity prior to approving them."[6]

Our charter analysis revealed that compared to our charter analysis three years ago, boards have significantly improved their documentation on this front. Yet, this improvement was also expected given that the EPS had established these expectations shortly after our analysis of 2014 charters. And, in fact, in light of this US regulatory focus, the significant progress that non-US G-SIBs have made in mandating these fundamental policy issues is probably even more notable.

02. Actively managing information flow, resources, capabilities, and committee discussions

The Fed proposal noted that "... boards of large financial institutions face significant information flow challenges. Although boards have oversight responsibilities over senior management, they are inherently disadvantaged given their dependence on senior management for the quality and availability of information."[7]

Hence, it was encouraging to discover that most board risk committee charters mandate that committee members have unfettered access to resources, including access to internal executives and information, and the ability to obtain external legal or expert advice. However, managing information flow between the risk and compensation committees is still not commonly stated in charters. Also, we found it alarming that not one US bank risk committee charter mandated training for committee members. Interestingly, non-US G-SIBs are ahead of the game on this front, with nearly one in three charters mentioning training for committee members.

4. The Fed's proposed BE guidance describes effective boards as those which: (1) set clear, aligned, and consistent direction regarding the firm's strategy and risk tolerance; (2) actively manage information flow and board discussions; (3) hold senior management accountable; (4) support the independence and stature of independent risk management and internal audit; and (5) maintain an effective board composition and governance structure; "Supervisory expectations for the board of directors," Board of Governors of the Federal Reserve System.
5. "Supervisory expectations for the board of directors," Board of Governors of the Federal Reserve System.
6. Ibid.
7. Ibid.

03. Holding senior management accountable for overall risk management, and for specific emerging risk issues

The Fed's BE guidance is specific about the board ensuring that management is held accountable for its actions, and that it keep abreast of emerging risks: "An effective board engages in robust and active inquiry into, among other things, drivers, indicators, and trends related to current and emerging risks."[8]

Our analysis showed that committees appear to have increased the qualitative heft associated with such language in charters. Although not up to US standards yet, non-US G-SIBs have made notable improvements on both of these documented language criteria. However, there is still progress to be made as regards identifying emerging risks and risk management deficiencies, and oversight of management's remedial actions. Also, despite a significant increase from a low base, while half of US banks' board risk committee charters mentioned oversight of model risk, discussions of third-party and conduct risk (both issues that have led to billions in fines for many large banks across the world)[9] were surprisingly limited.

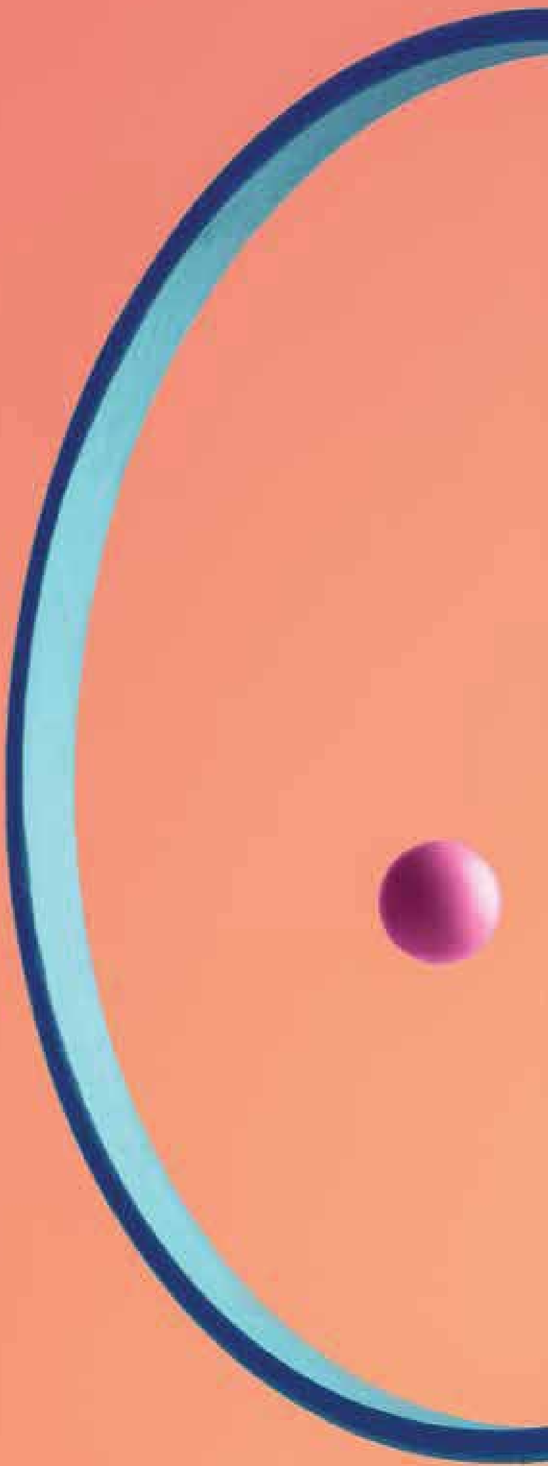
04. Supporting the independence and stature of the CRO, and risk management and compliance functions

There appears to be significant room for improvement regarding the board's role in elevating the stature and independence of the CRO, which the Fed's proposal also explicitly endorses: "An effective risk committee supports the stature and independence of the independent risk management function, including compliance, by communicating directly with the CRO on material risk management issues."[10] Although the charters of US bank risk committees generally mandated appointing and dismissing the CRO and ensuring that the CRO reports to both the committee and the CEO, only a few charters noted the committee's distinct role in terms of emphasizing the CRO's stature and authority within the institution. And only a little more than four in ten US bank charters include language ensuring the independence of the risk management function overall. Furthermore, the committee's role in integrating controls with management goals and the compensation structure, another EPS mandate, was rarely mentioned explicitly. Hence, it was no surprise that few charters mirrored BCBS guidance that encouraged the risk committee to report on the state of risk culture at the bank.

05. Maintaining an effective board risk committee composition and structure

As the Fed's BE guidance notes, "An effective board has a composition, governance structure, and established practices that support governing the firm in light of its asset size, complexity, scope of operations, risk profile, and other changes that occur over time... An effective board is composed of directors with a diversity of skills, knowledge, experience, and perspectives."[11]

Eight years since we began these charter analyses, almost every bank now has a dedicated risk committee, and most also have detailed charters or the equivalent. Of course, regulatory requirements and guidance played a defining role in this transition. However, what has also developed during this period is a wider gulf between the documented compositions of the risk committees of US banks versus those of non-US G-SIBs, which seem to rarely require the inclusion of a risk expert. And while the majority of US banks now insist that a majority (or, in some cases, all) of the members of the risk committee be independent, this is still not the case for non-US G-SIBs.



8. Ibid.
9. Gavin Finch, "World's biggest banks fined $321 billion since financial crisis," Bloomberg, 2 March 2017.
10. "Supervisory expectations for the board of directors," Board of Governors of the Federal Reserve System.
11. Ibid.

An effective risk committee supports the stature and independence of the independent risk management function, including compliance, by communicating directly with the CRO on material risk management issues.

Raising governance standards to navigate choppy seas

Now that we have analyzed our results in relation to the five supervisory expectations of the recent Fed BE proposal, we follow with analysis of how the risk committee mandates mesh with the six priorities of risk management in financial services firms as they look forward to 2018 and beyond.[12]

01. Present an effective challenge to the focus on strategic risk

Many institutions have established strategic risk working groups or centers of excellence that are owned by the CRO or the chief strategy officer (CSO) to proactively prepare for strategic threats.[13] The Fed, in addressing the governance side of the coin, notes that effective bank boards "set clear, aligned, and consistent direction regarding the firm's strategy and risk tolerance."[14] As we noted earlier, committees should look beyond metrics to evaluate why a strategy is working, probe what a failure would look like, and apply their analysis to the type and amount of enterprise risk appetite and risk management policies the institution should assume.

02. Oversee the rethinking of the three lines of defense

The delineation of risk control intended by the three lines of defense model—with business units owning and managing their specific risks, risk management providing independent oversight and challenges, and internal audit reviewing the effectiveness of the overall risk control framework—has been difficult for banks to achieve in practice.[15] The committee can help the stature and authority of risk managers through a strong control environment that includes empowering senior risk management executives with the authority to escalate emerging risk issues in a timely fashion to the board. Group risk committees should also ensure that local boards effectively challenge local business heads on risk and strategic issues that pertain to the soundness of country-level entities, whether branches or subsidiaries.

03. Stay vigilant as management tries to "do more with less"

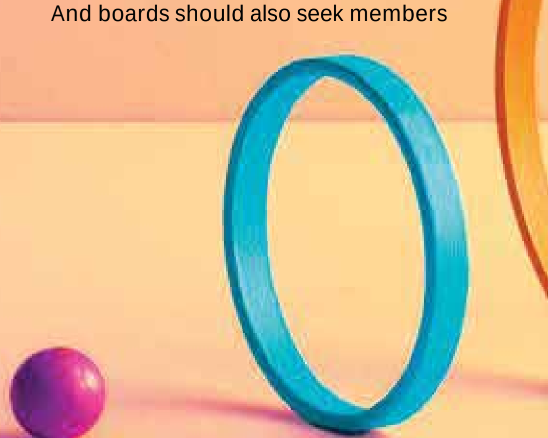
Advances in automation, machine learning, natural language processing, and Big Data techniques could help banks meet demands to optimize their internal risk and regulatory compliance footprint. Committee members should be dedicated to understanding and challenging the effective capabilities of new technology solutions—even in stress scenarios. Risk committees should also assess information flow in an automated risk reporting and control environment; these IT structures directly affect the bank's ability to identify and respond to emerging risks.

04. Strengthen formal conduct and culture programs

In the five-year period to ending in 2016, the world's biggest banks paid large sums in conduct-related charges, including fines, legal bills, and the cost of compensating mistreated customers.[16] Many banks have created conduct risk and culture programs, and regulatory focus on the issue of conduct has been more intense.[17] The first, likely obvious, step for risk committees is to clearly acknowledge oversight of conduct risk and risk culture in the language of their charters. Second, risk committee oversight of culture and conduct risk programs should look particularly at decision-making processes around product and service design, with a focus on senior management accountability.

05. Focus on the interconnectedness of risk

Many risks not only span the purview of specific business units, but of specialized committees outside and within the board of directors. Accordingly, board risk committees should work with other committees at board level (for example, technology, audit, remuneration, and operations) and with management risk committees embedded in businesses to identify and understand risk in a holistic way. And boards should also seek members



12. Edward Hida and Julian Leake, "The future of risk in financial services," Deloitte Touche Tohmatsu Limited, 2017.

13. Anna Mok and Ronnie Saha, "Strategic risk management in banking," Inside magazine, 2017 edition.

14. "Supervisory expectations for the board of directors," Board of Governors of the Federal Reserve System.

15. Hida and Leake, "The future of risk in financial services."

16. Jill Treanor, "World's biggest banks face £264 billion bill for poor conduct," The Guardian, 14 August 2017.

17. Deloitte, "Senior managers regime: Individual accountability and reasonable steps."

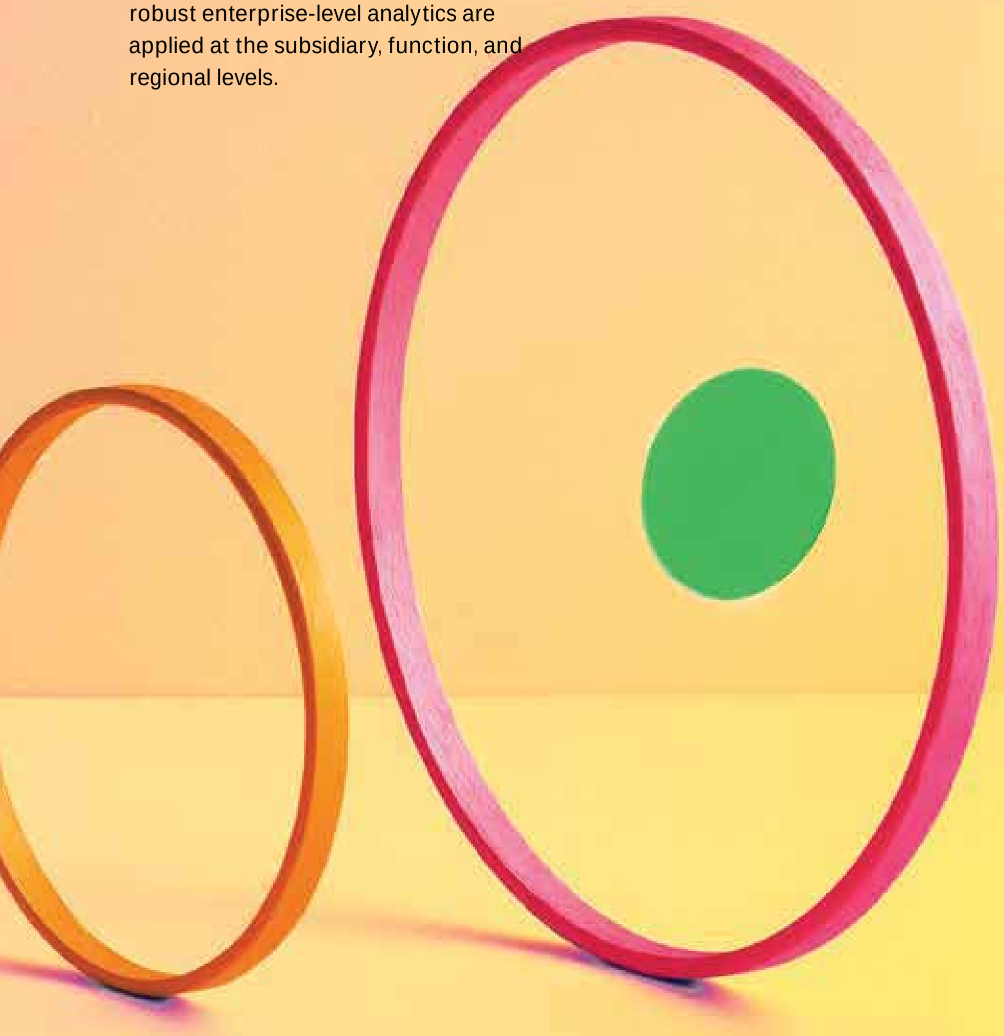
with new talent profiles, such as technology expertise.[18] Another way to approach interconnectedness is, of course, to prioritize training for risk committee members.

06. Oversee the strategic management of capital and liquidity
Of all the risk management capabilities that most banks have built since the financial crisis, capital and liquidity stress testing at an enterprise-wide level may have arguably matured the most. As our results demonstrate, risk committee and board attention to stress-testing programs seems to have likewise increased substantially. Risk committees should also ensure that robust enterprise-level analytics are applied at the subsidiary, function, and regional levels.

Orienting the compass to meet renewed expectations

In conclusion, as late as 2011, having a dedicated risk committee on the board was viewed as a leading practice, whereas it is now ubiquitous. However, as Fed Governor Daniel Tarullo remarked in 2014, it was becoming apparent that the increasing operational burdens placed on bank boards were drawing director attention away from strategy and risk-related oversight.[19] Hence, it would be a mistake to view the Fed's new guidance delineating board and management roles as an easing of expectations. As Fed Governor Jerome Powell remarked at the Large Bank Directors conference in Chicago earlier this year, "We do not intend that these reforms will lower the bar for boards or lighten the loads of directors."[20]

To meet and exceed expectations, board members should focus on creating robust information flow structures (especially around emerging risks), actively empowering the independent risk management function, and keeping pace with growing complexity in the risk environment.



18. John Reosti, "Cyber threats prompt run on tech experts for bank boards," American Banker, 17 May 2016.

19. Governor Daniel K. Tarullo, "Corporate governance and prudential regulation," Speech at the Association of American Law Schools 2014 Midyear Meeting, Washington, DC, 9 June 2014.

20. Governor Jerome H. Powell, "The role of boards at large financial firms."