Bank board risk governance

Driving performance through enhanced risk oversight

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During six consecutive quarters in 2013 and 2014, two groups of large US banks showed substantially different operating results. The average Return On Average Assets (ROAA) in one group was 57 percent higher. Otherwise—in terms of average total assets and other characteristics—the two groups were roughly similar.

A look at board risk committee charters of large banks

One key difference between the two groups was that the board risk committee charters of the higher-performing banks documented the need for a risk expert.[1]

Of course, correlation does not mean causation, and because it is only in recent times that the more rigorous risk governance practices have been introduced, it will be a while before one can examine the long-term relationship between robust risk governance and financial performance. Requiring a risk expert on the board risk committee is just a strong sign of a bank's commitment to risk management and governance, which, in theory, can exert positive influence on performance.

Many banks seem to have taken this lesson to heart. Efforts to strengthen risk management and instill appropriate policies and a risk intelligent culture throughout the organization have become top priorities for many banks. Major failures in risk management and oversight, some carrying heavy costs, show the stakes are high. Board risk committees, as the highest level of risk oversight, and crucial promoters of the "tone at the top," are increasingly focused on this transformation.

Regulatory expectations in the area of risk management are only adding to the pressures flowing from other regulations. In particular, in the United States, the Federal Reserve's Enhanced Prudential Standards (EPS) require bank holding companies to have additional risk governance standards in place as of January 1, 2015—a key driver of recent efforts. Internationally, the European Union's Capital Requirement Directive IV is likely having a similar impact on bank boards' risk governance practices.[2]

Another driver is the revised set of principles on bank corporate governance issued by the Basel Committee on Banking Supervision, which also encourage greater board-level risk oversight.[3]

In meeting these new standards, banks will need to show not only technical compliance with policy and process requirements, but also, increasingly, that their board risk committees are capable of presenting effective challenges to management decisions as part of their oversight duties. This is also stipulated by the Office of the Comptroller of the Currency's (OCC) Heightened Standards. In other words, these regulations have increased both director responsibility and potential liability.

Examining the board risk committee charters of bank holding companies enables us to make more informed evaluations of the current state of risk oversight, and provide some insight into the challenges banks face as they strive to comply with these new regulatory mandates.

An essential foundation of strong board-level oversight
We acknowledge that charters might not fully reflect all the actions, policies, and activities that board risk committees in these institutions actually follow. Likewise, there might be items in the charters that are not implemented in practice. As such, we suggest that our results be interpreted in that light. However, we believe that comprehensive, clear, and accurate risk committee charter documentation is an essential foundation of strong board-level oversight.

1 *This finding, drawn from analysis of our board risk committee charter research (see research methodology below) and SNL Financial's database, is limited to the set of banks studied during 2013-1H2014 period only. It is possible that there are other factors that contributed to the differences between the two groups of banks, but these were not readily apparent to us from the data. Read the paper on dupress.com for more detailed findings*

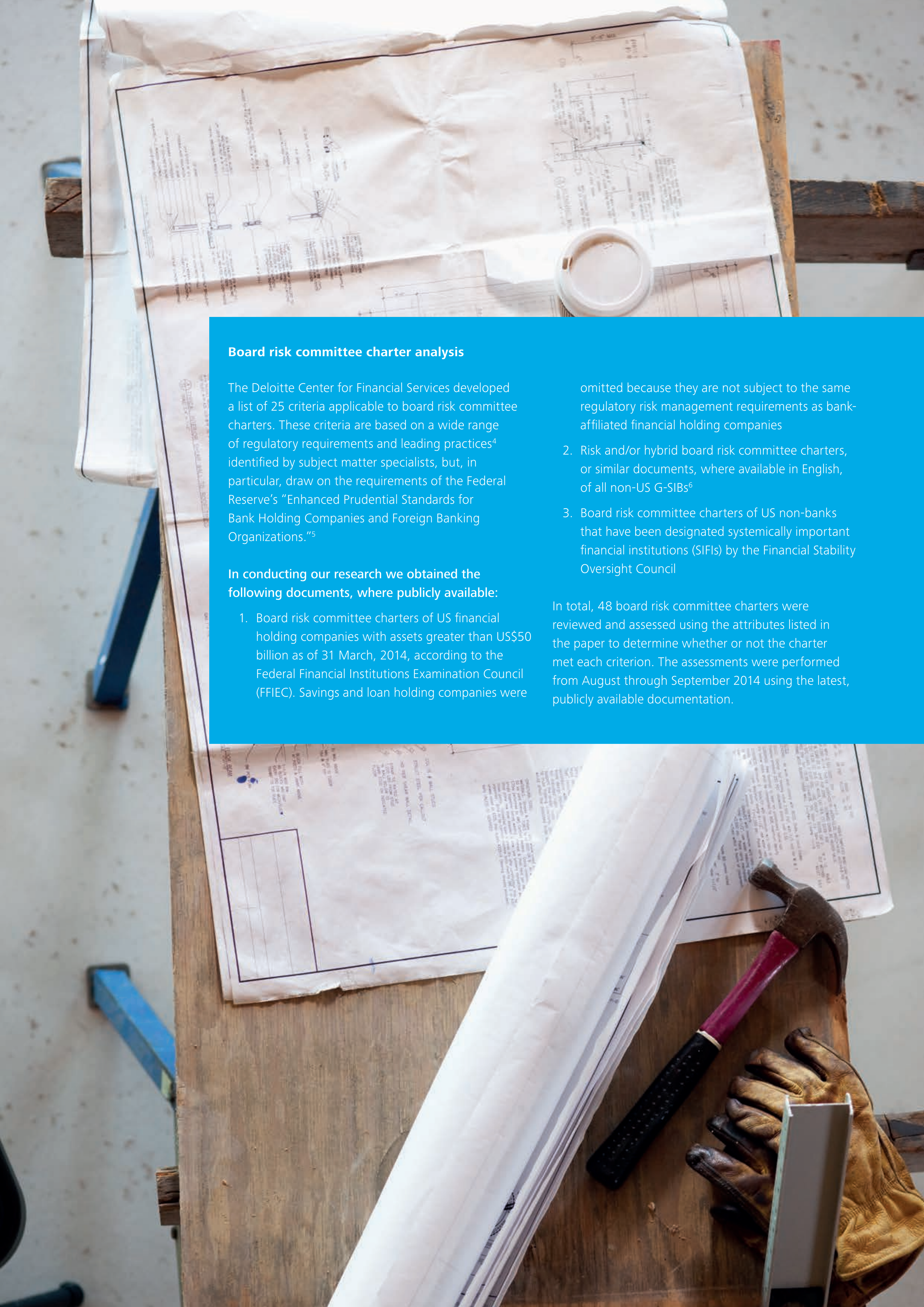
2 *"Capital requirements regulation and directive – CRR/CRD IV," 11 November, 2014, http://ec.europa.eu/finance/bank/regcapital/legislation-in-force/index_en.htm*

3 *Basel Committee on Banking Supervision, "Corporate governance principles for banks - consultative document," October 2014*

4 *In this paper, the term "leading practice" refers to risk policies, procedures, controls and frameworks that are not yet widely adopted in the marketplace, and are indicative of a higher level of risk governance maturity*

5 *Federal Reserve, "Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations: Final Rule," 27 March, 2014*

6 *G-SIBs identified using the Financial Stability Board's November 2013 list*



Board risk committee charter analysis

The Deloitte Center for Financial Services developed a list of 25 criteria applicable to board risk committee charters. These criteria are based on a wide range of regulatory requirements and leading practices[4] identified by subject matter specialists, but, in particular, draw on the requirements of the Federal Reserve's "Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations."[5]

In conducting our research we obtained the following documents, where publicly available:

1. Board risk committee charters of US financial holding companies with assets greater than US$50 billion as of 31 March, 2014, according to the Federal Financial Institutions Examination Council (FFIEC). Savings and loan holding companies were omitted because they are not subject to the same regulatory risk management requirements as bank-affiliated financial holding companies
2. Risk and/or hybrid board risk committee charters, or similar documents, where available in English, of all non-US G-SIBs[6]
3. Board risk committee charters of US non-banks that have been designated systemically important financial institutions (SIFIs) by the Financial Stability Oversight Council

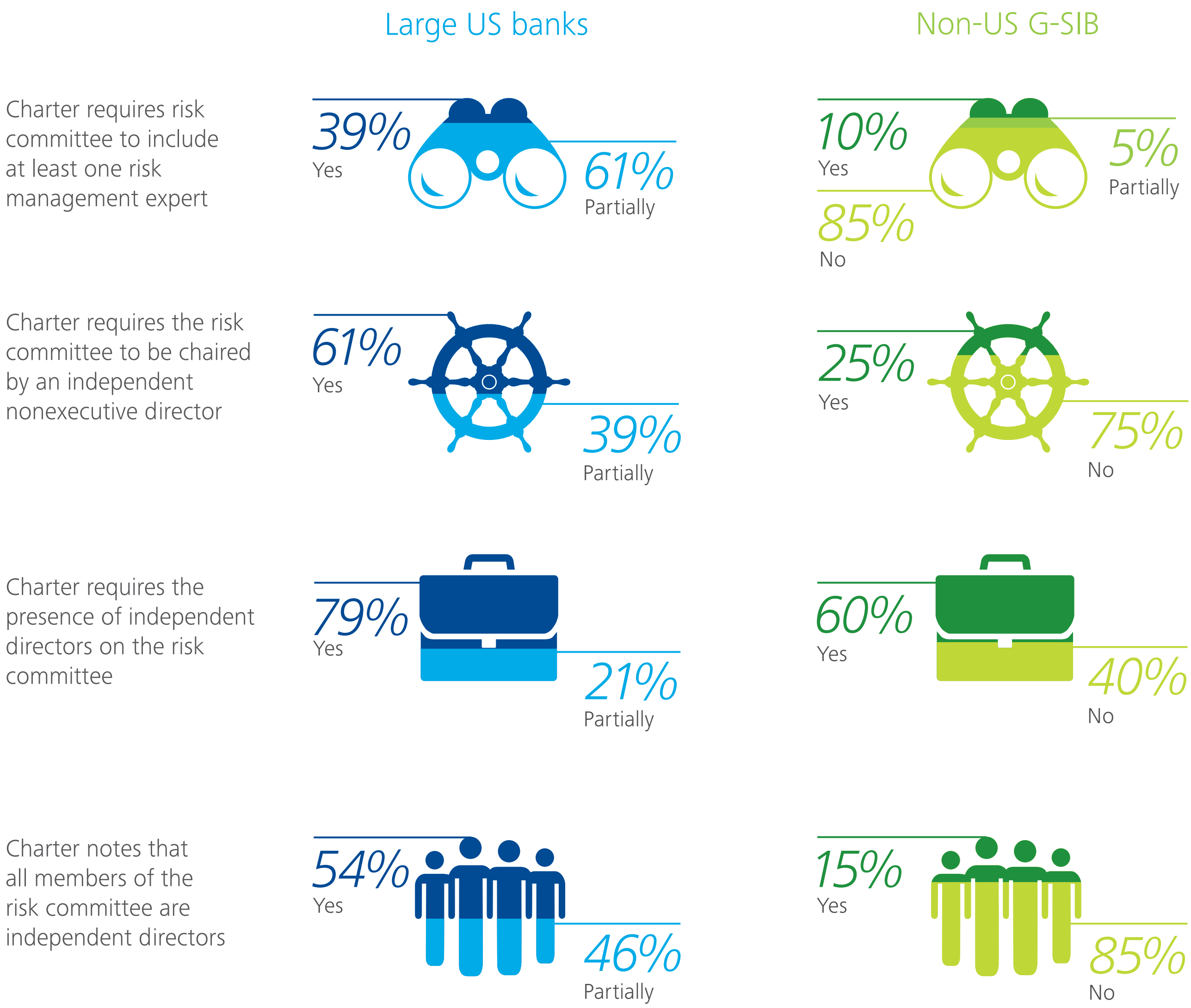
In total, 48 board risk committee charters were reviewed and assessed using the attributes listed in the paper to determine whether or not the charter met each criterion. The assessments were performed from August through September 2014 using the latest, publicly available documentation.

1. Evolving bank board risk committees: trends and findings

Continuing evidence of recent risk-management lapses have increased regulatory pressure. More stringent rules mandate new attention to structure, membership, reporting lines, and independence of bank boards and their risk committees.

Membership: room for improvement in expertise and independence requirements

Figure 1: Board risk committee membership



Source: Bank board risk committee charters and Deloitte Center for Financial Services analysis

As much as the scope of the committee matters, its composition may matter more. Committee members without the right mix of expertise and experience may be challenged by complex risk measures and regulatory issues.[7] Board risk committees without sufficient numbers of independent members may run afoul of regulatory mandates. More importantly, these shortcomings might limit board risk committees' ability to offer the perspective needed to avoid potentially costly gaps in oversight.

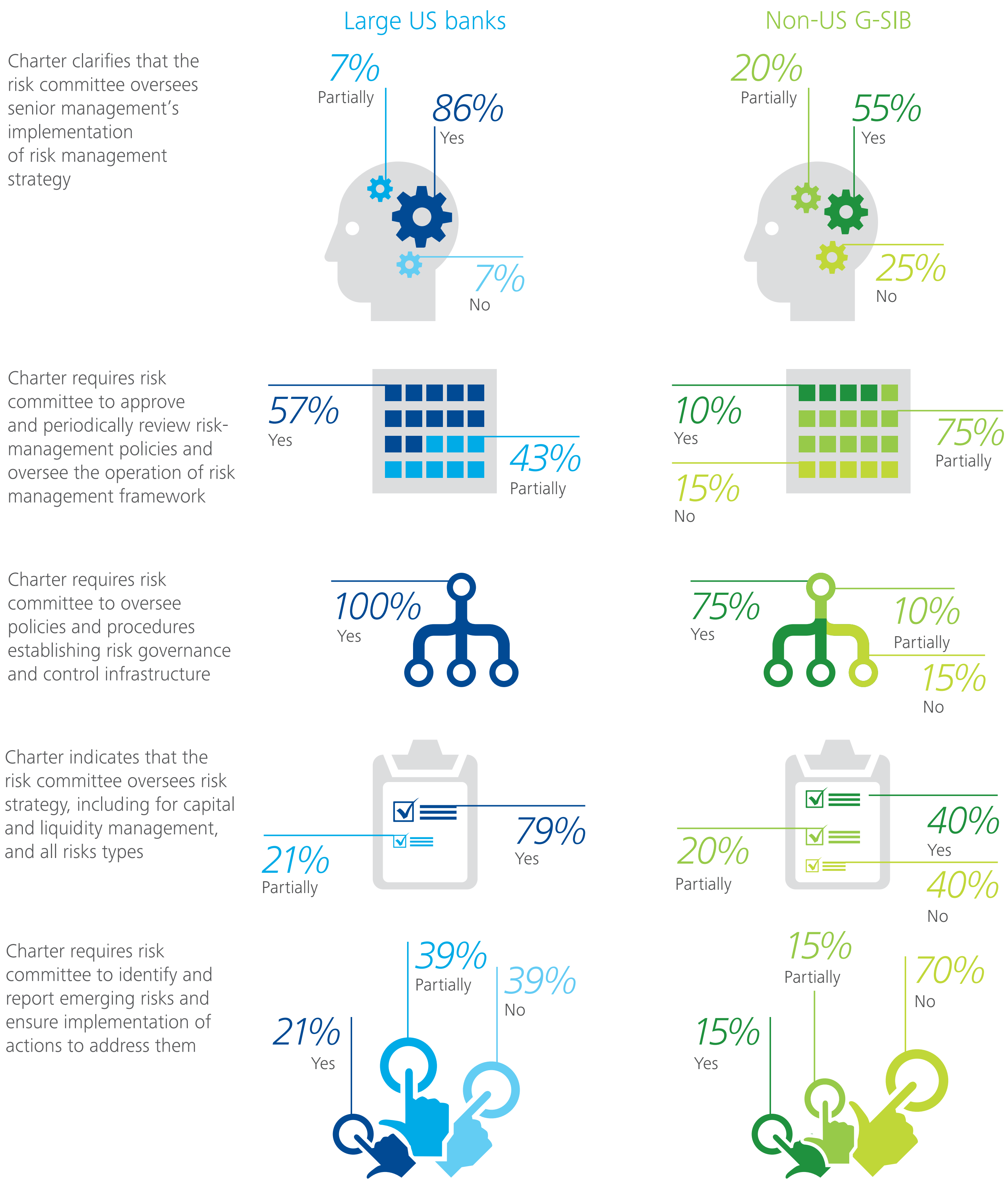
Looking again to board risk charters for evidence, it appears many US banks have missed the opportunity to document the composition of their risk committees (Figure 1). Just 39 percent of board risk charters require a committee member to have the "experience in identifying, assessing, and managing risk exposures of a large, complex financial firm," as required by the Federal Reserve's EPS. But there has been much improvement: in 2011, the last study we did of board risk committee charters, no banks had this requirement. A smaller percentage of non-US G-SIBS have specifically addressed this issue: only 15 percent of their charters mention risk expertise.

That said, both US banks and non-US G-SIBs appear to have taken steps to strengthen the independence of the committee. Nearly four in five US firms reviewed have documented a requirement for one or more independent directors on the risk committee, as do 60 percent of non-US G-SIBs. In our 2011 study, just 30 percent of US banks documented requiring an independent director.

7 *For bank holding companies with assets greater than US$50 billion, the Federal Reserve's Enhanced Prudential Standards define a risk management expert as someone with "experience in identifying, assessing, and managing risk exposures of large, complex financial firms."*

Increased responsibilities and scope of oversight

Figure 2. Board risk committee responsibilities



Source: Bank board risk committee charters and Deloitte Center for Financial Services analysis

To respond to their expanded responsibilities, board risk committees have seen an increase in the depth and breadth of their oversight authority. The heft of new requirements and notable performance difficulties have drawn focus to this issue. This is particularly noted in banks' efforts to meet the "effective challenge" standard expected by US regulators. (In brief, the "effective challenge" standard requires risk management practices to be critically examined by oversight bodies with sufficient competence, power, and incentives to generate change.[8])

The impact of increased expectations is gradually becoming visible in board risk charters (Figure 2). 100 percent of US banks' board risk committee charters and 75 percent of non-US G-SIBs' charters now require the board risk committee to oversee policies and procedures establishing risk-management governance and risk-control infrastructure (Figure 1).

This is also evident in the breadth of risks covered by the committee. Nearly 80 percent of US banks' board risk charters make committees responsible for oversight of exposure to a set of risk categories including not only credit risk, market risk, and operational risk, but also liquidity risk, reputational risk, and capital management.

However, only 57 percent of US banks' board risk charters place the responsibility to approve the firm's broad risk management policies with the board risk committee. This fact indicates that the board risk committees in nearly half the firms reviewed may be missing a key oversight mechanism. Still, US firms are significantly further ahead of their non-US counterparts in this respect: only 10 percent of non-US G-SIBs have such stated approval authority.

Nearly four in five US firms reviewed have documented a requirement for one or more independent directors on the risk committee, as do 60 percent of non-US G-SIBs

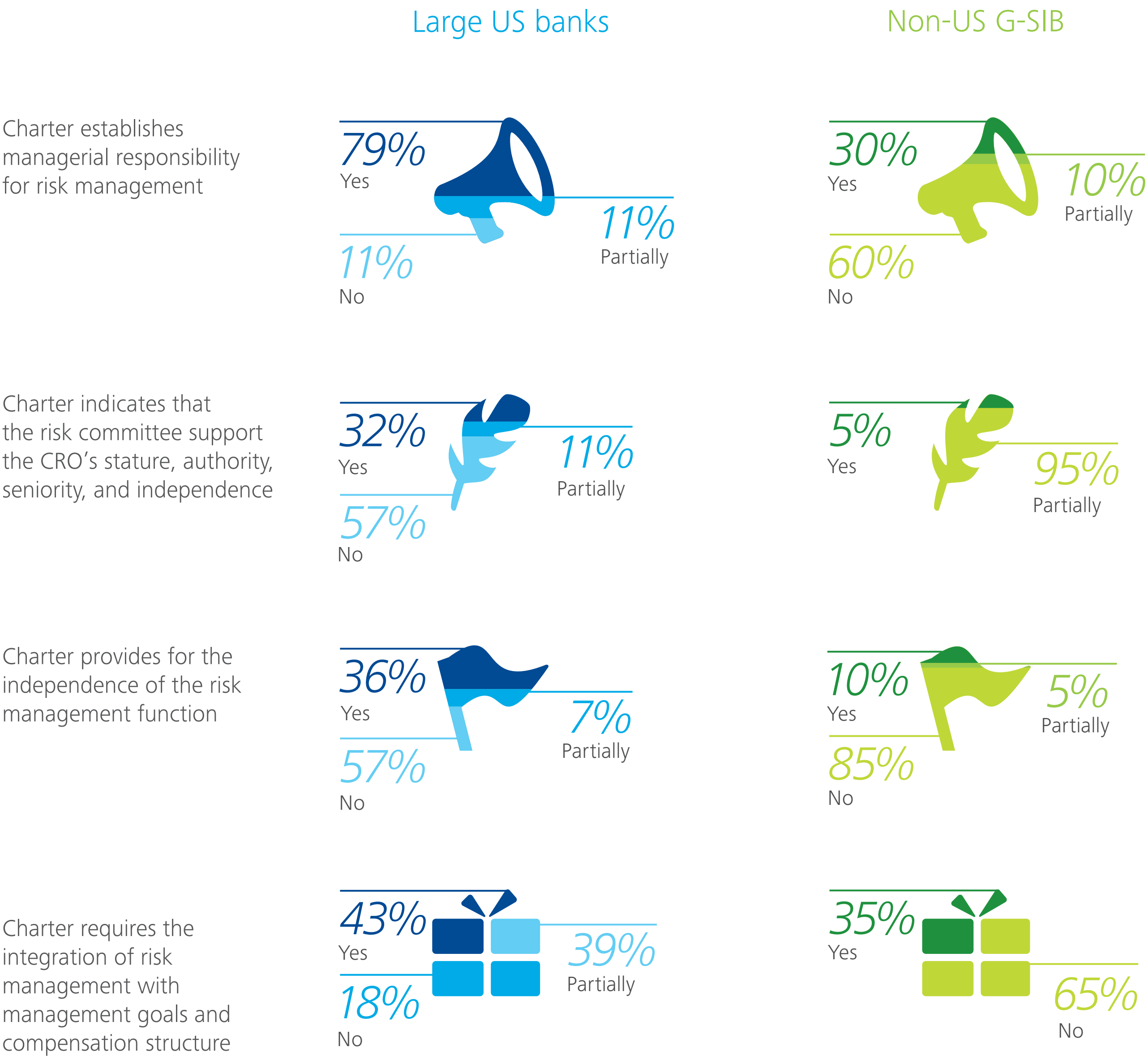
Risk oversight also seems to be rather reactive. Only one in five US bank risk committee charters (a) specify that alerts on emerging risks should be provided to the board risk committee and (b) authorize the committee's oversight of timely and effective remediation by management. Non-US G-SIBs show similarly muted resolution, with only 15 percent of their charters mentioning the communication of emerging risks and oversight of remediation. In other words, this is an area where there appears to be room for improvement.

This comprehensive oversight can give committee members greater understanding of the interplay of risks to which the firm is exposed, while giving them the focus needed to make sure they address emerging issues promptly.

8 *"Supervisory Guidance on Model Risk Management," Federal Reserve and OCC, 4 April, 2011*

Role in promoting independence of the risk management function

Figure 3. Board risk committee's role in protecting independence of CRO and risk management function



Source: Bank board risk committee charters and Deloitte Center for Financial Services analysis

Board risk committee charters indicate that many institutions take this responsibility seriously, but our study finds that US banks may need to make progress before they can sufficiently satisfy regulatory expectations—or at least better document the steps they have already taken. Most board risk charters of domestic banks either directly or indirectly establish management's responsibility for managing risk and the risk committee's oversight of this responsibility (Figure 3). However, only just above a third explicitly highlight the committee's role in requiring and fostering the independence of the risk management function.

Organizational reporting—both in terms of reporting lines and timing of formal reports—are a potential weak link in adequately supporting the risk management function. The board risk charter analysis indicates that establishing norms and safeguarding communication may be challenging banks. Only 36 percent of US firms' board risk charters explicitly require the CRO to report on risk management to the committee on at least a quarterly basis. Similarly, just 36 percent of board risk charters state that the CRO reports directly to both the risk committee and the bank's CEO. Both of these are governance expectations of the EPS.

Two other findings further identify places where banks can improve. First, only 32 percent of US banks' board risk charters have language indicating that the board risk committee actively supports the role of CRO such that the CRO has the independence and authority to fulfill his or her responsibilities. For example, the charter may specify that the board risk committees may review the CRO's hiring, compensation and incentive structure, and dismissal; may verify his or her freedom of action; and may take similar steps. This is a modest improvement from the 15 percent recorded in 2011, but could be higher and better documented. Second, only 11 percent of US banks' board risk committee charters document the ability of the CRO or other risk officers to communicate on an unscheduled basis with the committee. Progress in this area has also been modest for the global banks included in the study.

Role in driving risk awareness and culture

Setting the right tone at the top is critical for firms' efforts to improve risk management. But the lack of board-level documentation supporting the alignment of risk with incentive structures shows a missed opportunity to reinforce this tone. Our board risk committee charter analysis suggests that only 43 percent of US banks have mandated integration of risk management concerns into compensation, a regulatory requirement and one that is essential to strengthening firm wide risk culture.

2. Overcoming challenges in board risk governance

Now that the EPS standards are in effect for US bank holding companies with total assets above US$50 billion, firms should eschew the temptation to just meet the letter of the law and focus instead on implementing leading practices to enhance risk governance standards. By aiming high, these banks face numerous challenges (Figure 4, next page). However, they can overcome these hurdles with a combination of disciplined attention to standards and rigorous assessment of their committees' performance.

Figure 4: Overcoming implementation challenges

Challenge 1:
Enhancing authority and objectivity

Recommendations

- Bring all risk types into committee scope for a more comprehensive view of risk
- Create connections with other committees, but keep the risk committee in the primary oversight role for risk management
- Increase the number of independent directors on the risk committee

Challenge 2:
Building risk expertise

Recommendations

- Make sure at least one committee member has requisite risk expertise
- Educate other members on risk topics and regulatory expectations
- Ensure access to external experts

Challenge 3:
Strengthening risk reporting and independence

Recommendations

- Formally provide for senior risk management executives' (including the CROs') unrestricted access to the risk committee
- Create incentive structures that promote sound risk management

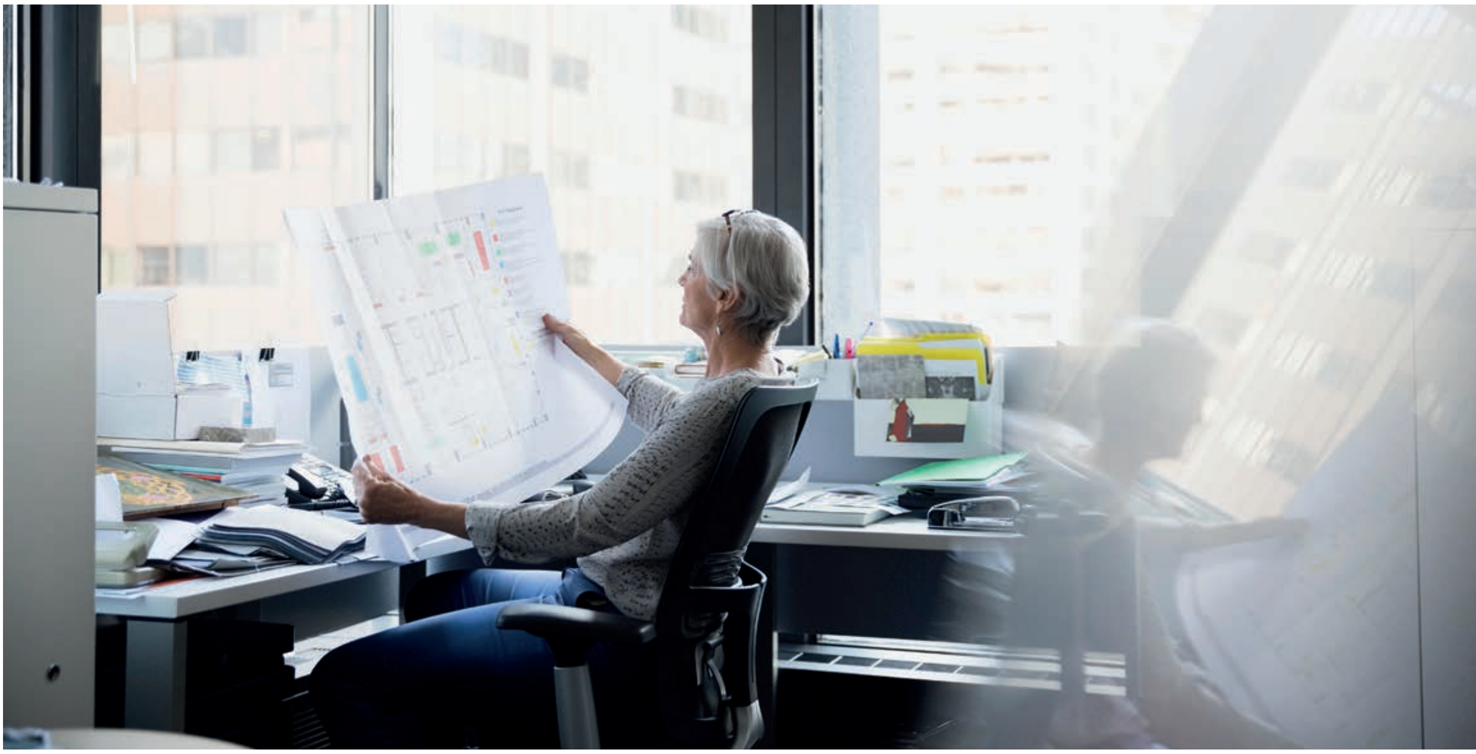
Challenge 1: Enhancing authority

Making sure board risk committees have sufficient authority and objectivity should be a top priority, but setting the right boundaries can be difficult in practice. The analysis of board risk charters, especially those of US banks, suggests that boards have strengthened risk committee powers. However, this authority may need further extension. One such area is the ability to oversee all risk types, including emerging risks such as cyber risk, to enable the committee to develop an integrated and comprehensive view of the firm's overall risk exposure.

Overcoming the challenge: The risk committee should have, under the purview of the board, responsibility and authority to review and approve risk management policy for all risk types. Liaising with other committees for better understanding of the firm's wider activities is helpful, even necessary, but the risk committee should be the ultimate overseer of risk policy.
An important factor in objectivity is the presence of independent directors—the Federal Reserve's EPS require the committee chair to be independent, while the OCC's Heightened Standards require two independent members. Given the importance of risk governance and the beneficial role of independent members, risk committees should seek more independent directors, and may even consider mandating a majority in their governing documents.

Challenge 2: Building risk expertise

Banks' risk exposures have grown exceedingly complex, making them steadily more difficult to understand for everyone, including experts. Accordingly, board risk committees need to continuously build the expertise



needed to fully understand the nature, extent, and potential impact of the risks that banks face.

Firms have found qualified directors with a financial background and experience in managing risks of large complex financial firms to be a limited talent pool. Additionally, many current directors may lack the technical knowledge or recent professional experience necessary to interpret quantitative risk data. This may limit their ability to form an independent view of risk and increases reliance on management's assessment.

"Board education is the biggest challenge."

Chief Risk Officer of a G-SIB

Overcoming the challenge: Committee composition should include at least one or two risk management experts—directors who satisfy regulatory expertise requirements. Other directors should have the requisite background to understand the bank's operating environment, risk policy, and regulatory expectations. In addition, these directors also should be educated about the key quantitative parameters that the firm uses to monitor risk and tolerance limits of those parameters, and the committee should have the authority to retain external risk and industry experts to supplement this knowledge when needed.

Cases in point: The board risk charter of ING Group explicitly requires members of the risk committee to have relevant business knowledge and adequate understanding of risk management related to the activities of the company and its group entities.[9]

9 *Charter of the Risk Committee of ING Group N.V., ING Group Website, last updated 11 February, 2014*

Challenge 3: Strengthening risk culture

Strengthened reporting structures and aligned risk and business incentives can help promote a risk-aware environment. Setting the right tone at the top is the single-most-used cliché when referring to board risk governance. However, extending responsibility and awareness of risk throughout the organization is no easy task.

Driving risk culture can be especially difficult for large organizations due to their inherent complexity. On the other hand, with regulators' eyes focused on large firms with a view to minimizing systemic risk, many smaller firms have yet to begin taking action to revamp their governance structures.

Overcoming the challenge: Fostering a strong risk culture should be as much of a board risk committee responsibility as that of senior management. Building senior management incentive structures that place a premium on being risk-aware is critical. Otherwise, governance efforts are likely to falter—with potentially serious consequences for performance.

Similarly, CROs and other senior risk personnel should have the flexibility to approach the committee at any time.

Case in point: The board risk committee charters of HSBC[10] and HSBC Bank USA,[11] HSBC's U.S. subsidiary, provide the CRO with direct access to the committee chair at all times.

Operational burden on US BHCs of foreign banks

Many large foreign banking organizations operating in the United States will need to establish Intermediate Holding Companies (IHCs) over their US banking and non-banking subsidiaries, as part of the new EPS requirements. Essentially, these foreign banks will now need to manage their US operations as if they were standalone US bank holding companies. To transition to this new structure, foreign banks face a number of difficult tasks. They will likely need to rationalize existing entities, establish new ones, and reallocate or raise new capital to fulfill new requirements.

In particular, many foreign banking organizations will have to create new capabilities to manage risk and capital at the IHC level. The upgrades entailed as these functions are separated from the parent company will need to be designed carefully to meet the complex array of new regulatory and business needs.

Overcoming the challenge: Banks should start early to meet the new compliance requirements. Fortunately, foreign banks can take some advantage of the slightly lengthened schedules (EPS compliance by 2016, for example) to learn leading practices from domestic organizations.

10 *Group Risk Committee Terms of Reference, HSBC Holdings PLC, last updated 1 August, 2014*
11 *Risk Committee Charter, HSBC Bank USA N.A., last updated 25 July, 2014*

3. Moving forward

As banks continue to revamp their risk management policies and practices, board-level risk governance should be a priority. Without careful attention to regulatory mandates and leading practices, banks may find themselves unprepared to meet ever-higher expectations. Perhaps more importantly, insufficient attention may lead to negative business consequences. As the data from our new study illustrate, many institutions have not yet shown sufficient focus.

This paper may help banks consider these crucial next moves. Our criteria and assessments indicate many basic steps toward an increasingly rigorous governance structure. Institutions that have yet to put these standards in place, or fully document them, may wish to use these as a short-term action plan.

In the longer term, however, the benefits may go beyond compliance. Some leading risk governance practices may be connected with improved performance outcomes. In an environment of continuing uncertainty and an elevated degree of regulatory risk, new investments in improved board risk governance may prove farsighted.