Board Evaluation

Is your Board ready for SREP governance reviews?

Deloitte Malta
Risk Advisory - Banking
Board agenda for banks 01
Key risks and challenges 02
Our framework 03
Core assessment tools 04
In-depth assessment tools 05
Why Deloitte? 07
Board agenda for banks

**Introduction**
Post-financial crisis, the global banking landscape has transformed significantly in reaction to economic, regulatory, supervisory and technological developments. Traditional business models are being challenged by insurgent disruptors, while new entrants struggle to comply with the vast regulatory framework.

**Sector developments**
In an attempt to restore confidence in the banking sector, the European regulatory framework was enhanced substantially with the implementation of Basel III through the CRD IV package, the introduction of the Bank Recovery and Resolution Directive (BRRD), as well as other regulatory reforms including updates to the Markets in Financial Instruments Directive (MiFID II), the Payment Services Directive (PSD II), and the Market Abuse Directive and Regulation (MAD/MAR). The European banking supervisory model was also enhanced, with the introduction of the Banking Union. Specifically, the Single Supervisory Mechanism (SSM) became directly responsible for all significant institutions in the Eurozone. This supervisory model increased scrutiny and expectations for European banks, with the SSM's supervisory approach also shaping the supervision of Less Significant Institutions (LSIs).

On an annual basis, the SSM publishes its supervisory priorities, as shaped by the pressing issues and challenges faced by banks as well as key risks to the European banking sector. Awareness of these priorities is important for banks in order to enhance their readiness for supervisory activities. The key risks highlighted by the SSM, as well as the supervisory priorities, should be discussed at board level to ensure that the bank is complying with regulatory developments, ready for supervisory inspections around the key focus areas, and effectively managing all key risks.
Key risks and challenges

**Technological advancements**
Traditional banking is being challenged by the wave of technological advancements. With the onset of mobile technology, social media and e-commerce, customer expectations have evolved. Customers are more demanding and want to be served instantly, with the click of a button.

Banks are thus being forced to rethink and adjust their business models in order to remain competitive, particularly with the influx of financial technology companies (fintechs) and technologies such as blockchain.

**Cyber risk**
With technological advancements such as the use of online banking, the occurrence of cybercrime events has increased significantly. Additionally, cybercrime methods are also becoming more sophisticated. Cyber risk has thus become a top priority for global regulators. In particular, banking supervisors are looking to ensure that banks are cyber resilient, and have the appropriate risk management procedures in place to withstand cyber-attacks.

**Money laundering risk**
In recent years the regulatory framework around anti-money laundering and the countering of terrorism financing has been enhanced. Nonetheless, events such as the ‘Panama Papers’ have put the spotlight on the effectiveness of supervisory regimes in this field. In addition to ensuring that procedures and monitoring systems are fully compliant with AML regulation, banks must also look to defend the sustainability of their correspondent banking relationships which are being threatened by the perceived increase in money laundering risk.

**Concentration risk**
Excessive concentration to certain industries and asset classes may mean elevated exposure to credit risk. Currently, the SSM is focusing on over-exposure to the shipping industry which is facing profitability issues. Furthermore, certain property markets across Europe are potentially over-heating. In the event of a property crash, banks that are exposed to such market will be impacted.

**Regulatory developments**
The sophisticated regulatory regime, as well as upcoming regulatory developments, puts additional pressure on banks, both in terms of cost and complexity to comply e.g. Post-financial crisis, the level of NPLs across Europe has remained significantly higher than countries such as the US and Japan, causing a drag on both profitability and credit growth. In an attempt to reduce the level of NPLs, the SSM launched an initiative requiring high-NPL banks to submit a NPL strategy.

Keeping up to date with regulatory developments is challenging, and furthermore, compliance generally requires adjustments to business models and governance set-ups. Trump’s proposed deregulation also creates uncertainty on the predictability of future European regulatory developments.

**Data quality**
Banks require high-quality data in order to ensure effective risk management and decision-making. However, legacy systems and poor data governance models, which are common across the banking sector, hinder access to accurate, consistent and appropriate data.
Our framework

We understand that effectiveness is more than structures and processes. It is also about the dynamics and behaviors of the individuals that comprise the Board and its Committees. Our framework focuses on how the Board discharges its key roles and the enablers that support the Board in fulfilling its responsibilities.

Gaining insight and foresight

The board as a whole and individual board members are aware of key policy, legislation and economic drivers alongside the current and future needs of key stakeholders, opportunities and threats, and the extent to which the organisation can effectively respond to these stakeholder needs and environmental conditions.

Clarifying priorities and defining expectations

The board has debated, agreed and clearly communicated a set of strategic priorities for the organisation and how it expects these priorities to be delivered.

Hold to account and seek assurance

The board is able to understand and critically appraise performance information, holds management to account and is reasonably assured that management is delivering these priorities in line with its expectations.
Core assessment tools

**Documentation review**
A thorough document review is essential to provide evidence and insight into the parameters within which the Board and the organisation are working, existing strengths and development areas, and any barriers to existing working practices.

Our review will include, at a high level, board and board committee management information, agendas and minutes, terms of reference, governance manual, board skills matrix and succession plan.

**Board observation**
This provides the opportunity to see the “board in action” and is extremely valuable in assessing board dynamics, the interaction between directors, the extent of challenge and debate, as well as considering individual members’ contributions.

Observing the board is also a crucial part of our assessment of the chairman’s leadership. We are also able to form a view of how the board papers are used by the directors.

**Individual interviews**
We would meet with every member of the board, as well as individuals who, although not members of the board, interact with or present to the board on a regular basis (“stakeholder interviews”). Interviews enable us to understand individual perspectives on Board effectiveness and provides interviewees with an opportunity to step back and reflect on how the organisation is run and what could be improved.
In-depth assessment tools

**Board survey**
We find that issuing a survey to Board members is a valuable process, enabling reporting of key themes and ensuring that interviews with directors are targeted. The survey seeks strengths and areas for development to light and highlight Board members’ opinions. Individual responses are shared on an anonymous basis. The survey can be used in future assessments for year on year comparisons.

Board committee observations
By also observing a number of board committee meetings we have the opportunity to consider the information flows between the board and board committees as part of our assessment of the effectiveness of individual committees.

In addition we can expand our review to cover board committee effectiveness.

If incorporated into the review, we apply the relevant elements of our framework to each of the board committees and to the governance structure supporting the board.

**Case studies**
In order to “get under the skin” of whether governance has been operating effectively and as intended, with your help we select two issues, transactions or significant decisions and understand the circumstances, escalation, approvals, and decisions in connections with these case studies. This technique can be useful and provide insight into how the organisation operates during a period of pressure, and importantly provides an evidenced-based way of demonstrating the board’s effectiveness.
Deloitte Tier Structure Model (TSM)
We use a Tier Structure Model, which sets out a continuum of increasingly sophisticated practices, ranging from poor practice (Tier 5) to market-leading (Tier 1). Clients value this approach because it is easy to understand, it clearly sets out a target best practice state which they can aspire to achieve; and for repeat reviews, it enables the board to visually track its progress from the last review.

Benefits of the Tier Structure Model
The content of the TSM 1 is based on:

- Our extensive experience of working with Boards;
- Our interpretations of PRA and FCA requirements, and;
- Best practice guidance, such as statements of effective practice issued by the Financial Reporting Council, the Financial Skills Partnership and the Basel Committee on Banking Supervision.

Given the qualitative basis of the assessment we have provided descriptors in tiers 1, 3 and 5 to enable evidence based judgement and differentiation within the assessment.

The TSM clearly depicts the current state of a Board's effectiveness against each of the components within our framework.
Deloitte has considerable experience working with boards and board committees, from small entities through to listed and regulated organisations. We have undertaken reviews as part of banks’ regular evaluations as well as at the request of regulators. We tailor our tools to your needs, allowing us to ensure that the review is proportionate to the complexity of your business.

We are a team of banking specialists with an in-depth knowledge of the Maltese banking industry and challenges faced by boards. In particular, we have a comprehensive understanding of the applicable regulatory requirements, guidance and expectations, in particular CRD IV requirements and expected SREP supervision.

The SREP governance areas are set out below. The areas which are fully or partly addressed by a Deloitte Board Evaluation exercise are indicated using a ‘thumbs-up’ below:

**Overall governance framework**
The assessment of the organisational structure of the institution as well as the suitability of the management body.

**Corporate and risk culture**
The adequacy of the risk and corporate risk culture taking into account the scale & complexity of the business.

**Organisation and functioning of management body**
The assessment of the: 1) oversight of the internal governance framework; and 2) efficacy of the interaction between management and the supervisory functions.

**Remuneration policies and practices**
The alignment of the remuneration guidelines and policy of the institution, with its risk strategy and compliance with CRD IV art. 94 and EBA Guidelines 2017.

**Internal control framework**
The review of the independence and effectiveness of the compliance and internal audit functions.

**Risk management framework**
Institution-wide assessment of the: 1) effectiveness of the role of the CRO; 2) risk appetite framework & strategy; and 3) stress testing capabilities.

**Information systems and BCP**
The suitability of information and communication systems and risk data aggregation capabilities.

**Recovery planning arrangement**
The assessment of the institution’s recovery plans, based on the findings from the internal governance assessment.
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A decade of continuously evolving regulations have placed a significant compliance burden on the banking sector. This has not only driven up costs, it has also hampered the ability of banks to respond to customer needs.

But if you view risk as a value creator, then you can see the opportunity to streamline and automate many aspects of the compliance process, creating a cost advantage. Banks that view risk as a driver of performance can use this cost advantage to not only attract new customers through competitive pricing, but they can also leverage the capital unleashed by this cost advantage to invest in their future prosperity.