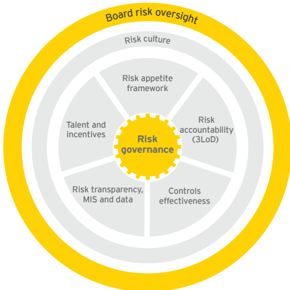
Board risk oversight



Bank boards are set to undergo further transformation

Risk Governance 2020

EY believes financial services firms face a sea change in how they approach risk governance.

Board risk oversight is one component of this overall effort.

The transformation required will take a comprehensive, multi-year effort to substantively complete. To remain at the forefront of today's market, firms should adopt an integrated approach that capitalizes on the value gained from upgrading risk governance: placing an equal focus on financial and nonfinancial risks in the short and long term, embedding evolving regulatory and supervisory expectations, and delivering tangible results in a cost-effective manner. We call it *Risk Governance 2020: a shift from satisfactory to effective and sustainable.*

Bank boards of directors[1] are approaching a tipping point in governance: regulators are pushing them further into overseeing strategy transformation, conduct and culture, and regulatory and other pressures are challenging existing business models and the structures and operations that support them. Important obligations related to risk and regulatory reform continue to be heaped on top of long-standing board responsibilities, such as those related to financial reporting and regulatory compliance.

Bank boards are now expected to oversee major changes in their institutions:

- Many banks are in the throes of multi-year transformations of their strategies, businesses, operating and structural models, and customer and digital strategies. Even those firms not planning major changes in their businesses have to consider the implications of change taking place around them, as well as regulatory expectations for reducing organizational and operational complexity and addressing conduct issues.
- Firms' approaches to risk governance are due for an overhaul if they are to balance addressing these imperatives while also overseeing strategy and forward-looking risks. In highlighting major and ongoing examples of misconduct, regulators are now pushing banks to significantly strengthen front-line accountability, embedded risk appetite, controls effectiveness and culture, each of which requires appreciable change in its own right and all of which are interdependent.
- Regulators continue to increase responsibilities and broaden expectations for the role of the board. Major emerging risks, notably cybersecurity, call for material board and senior management engagement.

1 For the purposes of this report, we use "director" to mean non-executive members of unitary (single-tier) boards and members of supervisory boards in those countries where two-tier boards exist.

Building a better working world

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However, adding more directors and committees or increasing time commitments is no longer a viable long-term solution. Agendas are already packed, training has expanded but is often limited in nature and utility, and reports are often filled with information but short on intelligence. New approaches are needed if directors are to offer credible and constructive challenge and guidance to the significant changes taking place in their organizations.

How should boards properly oversee these major issues?

- Directors recognize today's oversight challenge:
  - There is not enough time on agendas for dialogue on long-term strategy, senior management development and human resources, and major forward-looking risks – in the words of regulators, the opportunities to demonstrate effective challenge are limited by an increasingly tight agenda.
  - Compliance matters and regulatory issues dominate board and committee agendas.
  - Board reports are growing out of control – some risk or audit committee reports have gotten longer but useful analysis is still lacking.
  - Board committee roles and responsibilities are expanding but can be unclear and often overlapping.
  - Skills and competencies required by boards are changing significantly, and regulators' and investors' demands for new expertise (e.g., financial, risk, technology, human capital) create an environment where directors might be inclined to depend on other directors for specific expertise, rather than everyone taking on the onus to understand the issues.

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- Existing solutions are not sufficient:
  - Many boards have added more directors, committees or hours (or all of the above).
  - Boards are adding more retired executives, since they can commit more time, and are looking for non-executive directors with more banking or risk expertise.
  - Tactics to aid committee connectivity are being implemented, including more joint meetings, overlapping membership, more broadly distributed meetings and more effective meeting scheduling.
  - Firms are using tablet technology to make it somewhat easier to navigate materials.
  - The structure of board meetings is changing, with a move away from three- to five-hour meetings driven by a tight agenda to more use of separate workshops for issues, such as stress testing.
  - Boards have adopted broader training efforts, typically a roster of external training or networking events and conferences managed by the company secretary, and coupled them with periodic education sessions led by management.

These tactical changes have been helpful as boards have managed through the post-crisis reform of their focus and operations. However, even more significant change is needed both to deal with the additional demands being placed on boards and to enhance their ability to present an effective challenge to management and to oversee and guide strategy.

New thinking on how boards operate is required so directors can engage on strategy, conduct and culture

The board operating model has to be transformed, much as the firm itself is transforming. Banks are on the cusp of the third major overhaul of board practice in 15 years:

Reform one

Independence and internal controls

The post-dot-com upheaval brought in a major focus on audit committee responsibilities. The focus on internal controls around financial reporting was also enhanced (e.g., Sarbanes-Oxley 302 and 404), as was the need for effective whistleblowing mechanisms (see report below). The epoch of lead directors or independent board chairmen, coupled with the introduction of separate meetings of nonexecutive directors, greatly enhanced board independence.

Reform two

Risk oversight and regulatory remediation

Since the financial crisis, risk oversight has been pushed to the fore with the introduction of risk committees, risk appetite frameworks, expanded stress testing, and more detailed and expansive risk reporting. The board and risk committee in particular have played a major role in overseeing the implementation of stronger risk governance approaches and of risk-related regulation. Firms focused more attention on links between risk and compensation. These efforts are ongoing in the industry.

Reform three

Strategy, conduct and culture

Now regulatory changes and other pressures are pushing boards to focus more on bank strategies and on the structure and operations that will support execution and expected future performance. The pace and scale of change in the industry require substantive board engagement and challenge. At the same time, notwithstanding major investments and increases in headcount in risk and controls, regulators are indicating that the next major evolution needs to be in conduct and culture. Banks have not progressed on these issues as far as regulators expect.

Learn about EY's Center for Board Matters report *on considerations for audit committees as they fulfill their obligations under Sarbanes-Oxley 302* or visit ey.com/boardmatters.

The challenge for boards is that these transformations have brought additional responsibilities. The need for robust internal controls and credible financial reporting has not changed, nor has the critical importance of board independence. Similarly, ongoing risk oversight is crucial, particularly as macroeconomic concerns grow. Bank boards' strategic engagement and clear direction on conduct and culture are undoubtedly needed.

Board and committee agendas need a major overhaul

More aggressive agenda management is required. The tendency is to think everything is important or in a state of change, especially items related to law or regulation. Boards and committees need to have a systematic process to move regular agenda items into a business-as-usual (BAU) monitoring-and-oversight mode, so as to allow time for dialogue about emerging issues. Regulatory updates should focus on material and thematic developments and implications, and banks must avoid getting mired in every specific rule or regulatory examination finding.

Attention is required over areas that currently appear to be problem-free: those initiatives, controls and risks that appear "green" in a firm's dashboard but the success of which is critical, as well as those businesses experiencing significant growth and profitability and/or those upon which strategy is heavily dependent. Everyone remembers the fast-growing, ostensibly well-performing businesses before the crisis that ended up causing the problems — green can quickly turn to red.

On specific agendas:

- The **full board** needs more time on strategic and operational transformational changes, not simply updates on programs but a deep dialogue on the drivers and purpose of change, as well as the critical fundamental concepts on which the change is based. This requires directors to know and understand the fast-evolving, sector-wide changes that are taking place, the threats presented by existing and new competitors, and the value drivers in their firms.

  Exposing boards to thinking and learnings from outside the firm, and beyond the industry, may help. Industries such as chemicals or pharmaceuticals have had to reinvent themselves in a highly regulated environment, as have countless large multinational firms. Industries such as biotech and technology have to operate in a constant state of transformation, given the scale and pace of change and disruption. Other industries have had to reinvent how they cater to fast-changing customer needs.

- **Audit committees** have to ensure they focus on the critical factors of accounting, financial reporting and controls, and audit quality but not get mired in detailed processes. Audit committees have to provide oversight and challenge to management's revamp of three lines of defense, and they must make sure a firm's control framework remains robust, with clearly delineated roles and responsibilities and appropriate independent control and validation (see Board Matters report link). The audit committee is well placed to engage in the 3LoD overhaul. It oversees internal audit and generally has most board-level exposure to regulatory compliance. It also typically oversees other areas where a strong model for the first and second lines of defense is required (notably, legal and information technology).

- **Risk committees** have to find a way to evolve new oversight responsibilities linked to risks, such as liquidity, stress tests, models, risk appetite, risk governance and regulatory capital, into a more BAU oversight approach. Much as financial regulators are spending more time on emerging risks or elevated intrinsic risks in banks and the system, so too should risk committees. Again, outside perspectives are important. More generally, risk committees have to ensure that banks more effectively measure, monitor, mitigate and manage an array of nonfinancial risks; current approaches to do so have had limited success.

- **Compensation committees** may be changing their name to management development and compensation committees (MDCCs), but how much time do they really spend on management development and succession? How much is devoted to the firm's overall people strategy — hiring, training, recognition, promotion, firing — and how these actions affect culture? How much time is spent on existing nonfinancial incentives that can shape employees' behaviors as much, if not more so, than expected financial rewards? With risk culture high on the regulatory agenda, the MDCC has a major role to play.

- **Governance committees** have an important role in improving board and committee effectiveness. Clarity of roles and responsibilities of the board and committees will help minimize gaps and overlaps and support more effective director succession planning and onboarding. As regulators raise expectations for subsidiary boards, the governance committee can help clarify parent vs. subsidiary roles.

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The audit committee and disclosure effectiveness
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Boards should adopt a more integrated oversight process

Though board committees are critically important, in some ways they have inadvertently contributed to some of the siloed thinking in firms — e.g., the audit and risk committees oversee internal audit and compliance and risk, respectively, yet who owns the three lines as an integrated program? This is important, given regulators' recent push for strong front-line accountability for all risks inherent in the businesses and realigned and robust second and third lines.

Other such examples exist, such as ongoing massive technology transformations that have significant implications for risk, compliance and audit. The same is true for areas like big data. The recent focus on conduct risks spans multiple areas and touches the full board and every standing committee.

If management is to address these issues in an integrated manner, so too should boards.

Boards should establish time-limited oversight groups

Too often, boards resort to establishing new standing committees. Ten years ago, it was corporate social responsibility. Today, it is integrity/conduct or technology committees. These standing committees can be effective in addressing short- and intermediate-term issues; however, few firms cull such committees, perhaps so as not to signal that the underlying issues are no longer of major importance.

An alternative — one used routinely by management — is time-limited, less formal working groups that oversee the development and launch of major transformation plans and keep the entire board fully abreast of key issues, but that are disbanded as the project progresses and is successfully implemented and as the groups' roles are absorbed into BAU structures. Such groups could be established by the full board or its committees.

Unlike formal, standing board committee, such groups could be a mix of non-executive directors and management team members. Firms need not worry about such groups drawing directors too much into the business. Non-executive directors are competent enough to retain their independence; executives are smart enough to know accountability remains theirs.

Another approach is the regular review of committee mandates and their effectiveness in order to judge whether a separate standing committee is needed, or whether the issue has been integrated into the business. This would allow exception reporting to one of the main board committees.

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Board members have to invest more in education

It is difficult to imagine that, after a few hours of training and armed with a list of tough questions, directors can generally be sufficiently prepared to oversee complex transformational programs or ever-more-complex emerging risks. Do they really understand what's necessary to transform the bank's operating model in today's environment? Its digital strategy? Its three-lines-of-defense model? Its culture? Yet board members are being held accountable for overseeing and challenging such programs and, where necessary, directing change.

For many firms, a more integrated, ongoing and stronger board training program is required — one that is truly tailored to the needs of their board and the bank and that doesn't depend almost exclusively on training by management or generic outside events or conferences. Bespoke training should also be developed, and boards may need to bring in more external thinking, even if it runs contrary to management's view. This may require some directors to invest more time in education and training.

Dramatically different board risk reporting is required

Management is developing faster, more effective and more accurate ways to oversee performance, risks and controls. Senior managers are using technology to revamp the way this information is presented to allow for a high-level focus on key issues and trends and, if needed, multiple ways to drill down and analyze data. Boards need to acquire the same capabilities — not to micromanage the firm, but mainly to stay focused on the top issues, with the detail accessible for necessary interrogation, especially within committee dialogues.

Board materials should be fit for purpose with reports that enable decision-making formatted differently than those that are information-only. Similarly, where possible, reports should enable directors to refer back to strategic or key operational priorities, or to major firmwide initiatives.

The goal is a better board-level management information system, not simply putting more on a tablet or using board portals. It's about moving from data and information to intelligence, enabling better oversight, challenge and decision-making.

Boards may need to consider previously rejected proposals

Over the past decade, several suggestions for board reform have been proposed, but boards rebuffed them strongly. Two notable proposals were "full time" directors (those spending more than 75 days a year on their roles) and analytical support staff for boards. Both were viewed as potentially overstepping the role of the board by bringing directors into the realm of management.[3]

It may be time to revisit these ideas. In practice, some directors — notably audit and risk committee chairs — already spend considerable time on the roles, so the question for them is: do they spend their time optimally? Also, should certain other directors do the same, perhaps for a limited time?

Similarly, boards need more support, beyond administration. This has been met, to an extent, by engaging external advisors. The question is whether boards need dedicated internal staff. It seems possible to implement such an approach so that it enables board engagement and challenge on the most important issues, rather than pulling directors into day-to-day management. Several firms already have such an approach.

3 For example, some respondents queried the initial consultation on the Report on Corporate Governance in UK Banking, by Sir David Walker, for seeking to set what they viewed as too rigid minimum thresholds for director time commitment. Similarly, in private, directors responded negatively to a 2006 report by Moody's Investors Service on board support (Ken Bertsch, Francis Byrd and Mark Watson, "Do Boards of Directors Need More Direct Staff Support?," Moody's Investors Service, November 2006).

The boardroom in 2020

Many of these recommendations are already in practice at leading-edge firms. For many banks, however, the board of 2020 will look very different from today's. Some directors will spend much more time than others. Some committees will remain, and others will fade as the issues are addressed and solutions embedded. Meeting agendas will be materially different — time spent on compliance, regulation and other such issues will be a fraction of what is it today; in these areas, reporting by exception and consent agendas will be commonplace. In its place will be substantive dialogue on the most important issues of today and, more importantly, tomorrow. Technology increasingly will bring strategic and risk intelligence into the boardroom; board reports will be greatly winnowed down to reflect meaningful and actionable intelligence.

EY's *Risk Governance 2020*:
a shift from satisfactory to effective and sustainable

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