

Bank Governance Leadership Network Update

February 11, 2010

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Risk governance in transition: the CRO perspective

In 2009, Tapestry Networks and Ernst & Young launched an initiative that brought together directors and executives from leading banks to discuss the board governance and risk oversight challenges confronting them and their institutions. Eighteen directors from 11 European and North American institutions met in New York in October 2009, where they agreed that they have a central role to play in rebuilding trust in the industry, and in working with management and key external stakeholders to build a sustainable future for their institutions.¹

Since October, the dialogue among directors and executives, as well as key regulators and opinion formers, has continued.² They have emphasized that the political, regulatory, and economic environment continues to present real challenges, and much uncertainty remains – notably on the regulatory front. Chief risk officers (CROs) must deal with three demanding constituencies: board directors, whose inquiries they must address as boards engage more deeply on risk matters; regulators, for whom they serve as a primary contact point within the institution; and the CEO and business leaders, with whom they work closely to assess risks in specific trading positions, within each business, and across the firm overall. A number of key themes have emerged from recent discussions with board leaders and risk professionals:

- Regulatory uncertainty creates significant complications for CROs and risk committees.
- Risk chairs are diving deeper, but the line between oversight and management is still unclear.
- Board-level risk, strategy, and capital discussions are becoming more closely linked: businesses are the linchpin.
- Risk executives see a transition year ahead.

Regulatory uncertainty creates significant complications for CROs and risk committees

Improvements in risk governance and risk management have been the focus of many of our discussions. Rules are being rewritten (oftentimes differently by jurisdiction), and practices and roles are being redefined. The proposed reforms tackle perceived risk hot points, such as capital and liquidity management and compensation, and recommend a variety of solutions (systemic regulators and stress testing, for example), but much uncertainty remains. One thing that seems sure, however, is that greater regulatory intervention will be a fixture of the industry environment for some time to come.

In that context, the roles of the chief risk officer and the risk committee are becoming significantly more challenging. The lack of coordination among regulatory authorities in different countries, and even between regulators within the same country, exacerbates the problems. Participants in our discussions point to three important consequences of more active, yet uncoordinated, regulatory intervention on risk: the “crowding

¹ The four *ViewPoints* documents generated by the Financial Institution Directors Summit are available as a single report, entitled [Invigorating bank governance in a new era](#).

² We have spoken with over 45 bank board members and senior bank executives, including chief risk officers, since October 2009.

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out” of other critical activities of the risk function, a more reactive stance on the part of boards and risk committees, and mixed messages on compensation.

- **Dealing with regulatory matters “crowds out” other critical risk activities.** The growing list of vaguely defined and sometimes duplicative regulatory reporting requirements is a major drain on the time and resources of the risk function. At some banks, regulatory matters now take up 40% of the risk organization’s time. At one organization, the CRO is currently completing 19 separate surveys in response to regulatory requests; another CRO has identified over 200 best practices that regulators are asking firms to benchmark themselves against. Some institutions are considering having all regulatory activities report up to the CRO. Given this focus on regulation (some organizations are having all people who handle regulation report to the CRO), in the future, “CRO” may mean chief regulatory officer as well as chief risk officer. Risk executives point out that, ironically, *“in the end, this means we are spending less time looking for risks, analyzing risk, and helping to position the firm for success.”*

CROs also point out that some of the increasing demands on risk executives’ time are coming from the board – not just from regulators. Several risk chairs refute the assertion that they are radically reshaping the CRO’s role; one reasoned that *“the regulators and the CEO are shaping that role, not me.”* However, with risk committees becoming more active – and at some banks, in the process of defining their role as a new committee – risk executives are spending more and more time on committee work. As one CRO put it, *“[we are in] constant meeting prep mode.”*

- **Boards and risk committees may be taking a more reactive stance.** CROs observe that directors and committee chairs remain extremely sensitive to the regulatory and political climate: *“No one wants to be on the front page of the newspapers. The board is watching for every twitch from the politicians and regulators.”* One executive noted, *“Directors are worried: it shouldn’t impact their behavior, but it will ... Boards just want to get through and stay under the radar.”* Some directors agree; one acknowledged, *“Boards are spending much more time on regulatory matters. Strategic thinking, [which is a key] role of the board, kind of becomes impossible in this environment.”* But even though it is reasonable to be focused on regulators’ concerns, participants said, *“We can’t stay in all-defense mode; it’s a losing proposition.”*
- **Regulators expect risk professionals to be actively involved in compensation, but they do not always like the results.** Regulators have pressed risk and compensation committees to involve CROs much more actively in compensation discussions. Risk professionals report this involvement is taking numerous forms, from participating in 360-degree reviews of top executives to simply verifying on an annual basis that the compensation plans *“don’t incent bad behavior.”* However, several CROs said that regulators seem unwilling to hear what they have to say – namely, that *“competitive compensation matters”* if banks intend to retain and attract top talent at a time when the industry is under fire. One participant said, *“Regulators seem to want to use compensation as a lever to de-risk the industry,”* but then are unhappy with banks’ decisions to reward employees who do successfully bring risk levels down, because returns have gone down in parallel with the level of risk.

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Risk chairs are diving deeper, but the line between oversight and management is still unclear

Regulators and investors have made it clear that they want boards to get much more intimately involved in risk matters. They want boards to have a firmer understanding of the key risks facing the business. Hearing this call for more involvement, directors have set about improving their risk oversight. Some have made evolutionary improvements, while others have significantly stepped up their oversight activities (notably, those that established risk committees over the last 12 months).

Directors and executives are keenly aware of the potential for directors to become so deeply involved in their institutions' risk-taking decisions that they end up overstepping the boundaries of their oversight role. Yet, there seems to be some disagreement about what constitutes crossing the line. Several directors assert that they are successfully increasing their engagement in risk matters in a way that equips them for more informed strategic discussions, without moving into management's territory. As one board member put it, *"While it's true we're more [involved], the [risk] metrics are drawing us up from the details, not down into the details ... We are stepping up from looking at a list of companies [we have as clients] and how much capital we have committed [to each]."*

Some risk executives feel differently, however. *"I don't think our board has found the right balance yet,"* stated one CRO. Another agreed: *"It's still an open question [as to] how boards can get more engaged without crossing the line."*

With the regulatory environment in flux, the potential for confusion on the appropriate role for risk committees – and boards – on risk will surely remain. In the meantime, CROs believe that time spent educating boards members on risk matters is a worthwhile investment. In fact, in their view, more education may be necessary. One CRO noted, *"Board members need significantly more training [on risk issues], so they can contribute better ... Many unfortunately aren't there yet."* Another stressed the importance of having all board members, and not just some, understand risk. Otherwise, *"[the] board effectively separates into two tiers: those who really understand the firm's risks, and those who don't."*

Board-level risk, strategy, and capital discussions are becoming more closely linked: businesses are the linchpin

According to many executives and board members, much of the regulatory and investor focus on risk in the banking sector has been on eliminating downside risk and *"avoiding mistakes."* The theory behind this focus is that if banks can decrease risk levels, the industry's problems will be largely resolved. Yet, directors attending the 2009 summit stressed that risk avoidance is just one part of the equation; it needs to be discussed and reviewed in the context of the firm's strategy and future performance goals.

Since the summit, that is exactly what has happened: discussions on risk governance, capital matters, and firm strategy have converged. Risk executives agree, noting, *"Risk is in the room now for all strategic discussions."* A CRO commented, *"We struggled for three years, [but] this year we really linked [risk*

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appetite] ... to strategy. One doesn't come before the other." However, directors and executives point to three areas where challenges remain:

- **Developing strategy in the context of regulatory uncertainty.** Several participants noted that it is challenging to set long-term strategy while regulators and politicians are still debating the future structure of the industry and while capital and liquidity requirements for key lines of business have not yet been finalized. One subject matter expert said, *"Boards and management teams have to put aside their three-year business planning approaches for the time being and instead equip themselves to [more adroitly] navigate the constantly changing regulatory environment."* Yet, directors and executives strongly disagree with the notion that strategic discussions should be put on hold. One participant noted, *"You can't tell employees and shareholders, 'We don't know what we want to be when we grow up.'"*
- **Being sufficiently forward looking.** Risk chairs insist that they must focus their attention on the future and avoid the dangers of dwelling on the risks of the past. Reevaluating past mistakes has limited and diminishing value. One chair noted, *"At least half of the discussion at the risk committee is not looking back, but taking time for a general discussion on the main risks we expect in the next 6, 12 months ... We're taking a more holistic, more judgment-based approach."* Another chair of a newly established risk committee only took on the role on the agreement that his committee would focus on the future.
- **Ensuring that business leaders remain accountable for risk.** Directors and risk executives emphasize that businesses and the board, not the risk organization, must take the lead in risk and strategy decision making. Indeed, banks have adopted approaches that visibly emphasize this ownership. One CRO noted, *"We've deliberately moved away from presentations by the risk organization at [risk] committee meetings. It has to be done by the business, not the risk guy who covers that business."* Another risk executive described a process whereby *"the business leaders talk through their view on risks, and then they're asked to leave. Then the board asks me [to comment]."* This is consistent with the view expressed by other participants that *"if [directors] want to talk about risks, don't talk to the risk organization; talk to the business people, with the risk team there, and also without them."*

Risk executives see a transition year ahead

Risk professionals universally see 2010 as a pivotal year in which boards and management teams will get greater insight into the environment in which they will operate in the future. They predict that directors will continue to move up the learning curve on risk matters as they answer regulators' call to get more actively engaged.

They expect that regulators will start implementing Basel III capital and liquidity rules in earnest. They also expect regulators to turn their attention to consumer protection regulation. In the meantime, they predict that debate over structural remedies for institutions that are "too big to fail" will continue; the solutions that materialize may take either cross-border or, less helpfully, competing national forms.

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For their part, bank board leaders will need to decide how to respond to pressure from external stakeholder groups, including policymakers, regulators, and investors. Will they “*get through and stay under the radar?*” Or will they seek opportunities to engage actively in dialogue to educate stakeholders, communicate the potential unintended consequences of proposed reforms, and share their views on solutions that will help to rebuild trust and support recovery?

Above all, risk executives and board members expect to work together more closely than ever to help their firms navigate the uncharted waters ahead. As one senior executive put it, “[*When*] boards and management work together effectively, it can be very powerful. Going forward, this won’t be a luxury; it will be critical.”

About this document

The Bank Governance Leadership Network is a group of non-executive directors from North American and European financial institutions brought together to share perspectives on proposals for strengthening corporate governance. Their peer-to-peer discussions are informed by conversations with bank directors, executives, regulators, investors, and other key stakeholders. Tapestry Networks conducted the research, orchestrated the discussions, and prepared this memo. Ernst & Young sponsors the research as part of its deep, continuing commitment to board effectiveness and good governance.

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