

Risk governance in a new era¹

The Senior Supervisors Group noted in March 2008 that financial institutions (FIs) would “face increasing pressure to understand the risk they face, to measure and assess such risks appropriately, and to take the necessary steps to reduce, hedge, or otherwise manage such risk exposures.”² With the benefit of hindsight, this seems like a considerable understatement.

Since the early days of the financial crisis, leaders both within and outside the financial services industry have highlighted the need for boards to improve in the area of risk governance. As one director³ put it at the Financial Institution Directors Summit⁴ on October 5 and 6, 2009, “*The biggest [challenge] that I struggle with is dealing with the balance between growth, returns, and risk management. All of our assumptions didn’t work.*”

This *ViewPoints*⁵ outlines the discussion at the Financial Institution Directors Summit on the future of risk governance and draws upon extensive research developed in preparation for the summit meeting.⁶ See “[About this document](#)” (page 14) for more on the research and “[FI Directors Summit participants](#)” for a list of attendees.

At the summit, directors and guests discussed four imperatives for boards as they tackle the issue of risk governance:

- **Setting risks in a strategic context** (*Page 2*)

Directors emphasized that board-level risk discussions must take place in the context of firm strategy and performance goals. Board leaders recognize their responsibility to actively challenge management on the question of whether the firm has the necessary resources, including financial and human capital, to be successful in executing the firm’s strategy.

- **Ensuring risk appetite is more clearly defined and better understood** (*Page 3*)

Board leaders view risk appetite as perhaps the most critical component of an overall board-level risk policy, because it acts as a clear statement of the firm’s strategic intent. Virtually unanimously, directors at the summit and participants in prior research believe bank board members need to have greater, and more constructive, involvement in their firms’ decisions regarding risk appetite. Challenges related to risk appetite include clarifying the board’s role, developing well-informed definitions, and communicating to external stakeholders.

- **Defining the risk governance agenda** (*Page 6*)

In the post-crisis era, FI boards need to clearly define the risk governance responsibilities they will assume. Summit participants expect to remain more actively engaged on a broader set of risk priorities than they were before the crisis. They highlighted capital allocation, new business risks, and risk-adjusting compensation as issues that have risen in importance on the board’s agenda in the current environment.

- **Enhancing the board's understanding of risks** (*Page 9*)

To support robust discussion and debate on risk matters, directors require high-quality information and insight from both within and outside the firm. Streamlining risk communications to the board, establishing a productive relationship with the chief risk officer (CRO), and drawing upon independent risk perspectives all contribute to building the board's risk knowledge.

Setting risks in a strategic context

The global financial crisis that has gripped the banking sector revealed that boards and management did not fully appreciate the overall level of risk to which their institutions were exposed. Prior to the summit, one regulator asserted, "Boards didn't ask enough questions to ensure they understood [their institutions'] risks or [to] identify the concentration of risks. They didn't demand that risks be made transparent." A chief executive acknowledged, "[Over] the past few years, we thought we had dispersed risk. We forgot the basics: the identification, allocation, and pricing of risks."

In the wake of the crisis, board members report an evolution in thinking about the board's role in risk matters. Where in the past many FI boards focused primarily on ensuring their institutions' risk management and control processes were sound, now directors are keenly aware that in addition, they must engage much more actively with the substance of the institution's risks and ensure those risks are viewed in the appropriate strategic context. "[We] can't have a risk discussion without [discussing] strategy. There has to be a link between our strategy, the resources [the firm] has available, and our performance objectives ... This is a key responsibility of the board, and it can't be delegated," stated one summit participant. Another agreed: "I am interested in [how the board] can move beyond the regulatory compliance process to an understanding of management's assumptions, particularly on risk." Summit guest Brady Dougan, the CEO of Credit Suisse, noted the essential role that boards and committees play in ensuring management does not get overwhelmed by the details of complex risk matters: "The risk committee helps keep us focused and gives us perspective. Management can often get into the weeds, and the board can be really helpful in getting us to step back."

Directors at the summit emphasized, however, that keeping board-level risk discussions in a strategic context does not mean that those discussions stay at an abstract or superficial level. They identified two areas in particular where boards will need to go deep:

- **Understanding the business.** The board, and in particular the committee tasked with responsibility for risk oversight, needs to understand each line of business and its respective volatility so that it can probe management's assumptions on risk. "We have to understand the ROE [return on equity] ... by business, over the [economic] cycle," commented one director. Another agreed: "We have [multiple] lines of business at my bank, and we understand what the ROE should be for all of them. If one of them should be earning 20%, but is earning 30%, [the board] is going to go digging. That's too much risk."

- **Understanding management capabilities.** Within each of those lines of business, boards need a greater degree of familiarity with the level of management capability relative to the competition. One director noted, *“If management came to our board and said ‘We want to do more business in Russia,’ we’d say, ‘We want to know who our managers are in Russia.’”* Another summit participant summed it up simply: *“We have to recognize [risk] isn’t just the numbers. It’s the people. That’s why the board has to get more involvement and face time with the key executives.”*

Summit participants concluded that above all, boards must stay actively engaged in guiding their firms’ strategy and business model choices: *“Depending on the volatility you are ready to accept,”* one director observed, *“you decide what kind of institution you want to be ... and what type of shareholders you want to have. The board should set that definition.”* Participants expect the challenges in this regard – ones that may include significant changes to the industry’s structure – will only increase as global economies continue to recover and pressure for returns comes to the fore: *“What happens when ... fear [gives way] to normalcy?”* One participant reported seeing things change already, for some shareholders: *“A number of our investors have already moved on from the crisis. They’ve said, ‘You can’t make money only serving clients, and you’re holding too much capital.’”*

Ensuring risk appetite is more clearly defined and better understood

Banking is fundamentally a risk business; as such, risk appetite can be broadly defined as “a measure of the amount of total risk [an institution] is willing to accept in pursuit of its business objectives and goals.”⁷ Thus, it can be seen as one important articulation of the strategy agreed by the board and management. In a recent report, the senior FI supervisors from seven countries stated bluntly that “most firms [do] not present much evidence of active board involvement in overseeing the setting or monitoring of the company’s risk appetite, or of board understanding of the firm’s current risk position relative to its risk appetite.”⁸ Key challenges highlighted by summit participants include clarifying the board’s role in risk appetite, defining risk appetite, and communicating risk appetite to external stakeholders.

Clarifying the board’s role in risk appetite

Prior to the summit, a regulator commented, “Risk appetite is where the board’s role really begins.” But what should that role be? One participant asked, at the outset of the summit, *“Where does management stop and the board take over [with respect to risk appetite]?”* Directors largely agreed that risk appetite should be set by management and approved, after sufficient examination, by the board.

Regulatory guests concurred with this view, but emphasized their expectation that directors will engage much more actively on risk appetite than they have in the past. Sally Dewar, the managing director for risk at the UK’s Financial Services Authority (FSA), stated, *“Management should set risk appetite, but the board should delve into the details enough to get comfortable with it.”* Bill Rutledge, the executive vice president of the Bank Supervision Group of the Federal Reserve Bank of New York, noted that regulatory authorities want to know *“how deeply is the board*

engaged in risk appetite? Are they monitoring the actual [risk level] versus what was set? Are they [ensuring management is] being forward looking in ... identifying action steps to be taken if risks do materialize and losses show up? We view these as challenges for boards.”

Directors and executives also believe there is room for boards and key committees to get more deeply involved in exploring and, where necessary, challenging management’s proposals on risk appetite without crossing the line into management’s responsibilities. At the summit, several board leaders highlighted instances where their boards had pushed management to withdraw from certain businesses, because they felt the associated risks were higher than those perceived by management. “It is within the board’s power to say, ‘We are willing to take this amount of risk under the following assumptions,’ without getting involved in day-to-day ... business decisions,” stated one director prior to the summit. Another board member emphasized, “The board needs to be active [in risk matters], but at some point there’s a danger of becoming another organ of management. It’s a better idea to simply replace management if we don’t trust them, rather than crossing that line.”

Defining risk appetite

A statement on risk appetite sets forth the company’s general attitude toward risk, consistent with its strategic objectives. At the conceptual level, this is both simple and profound. In a pre-summit conversation, one director observed, “It’s the great balance of [this] business: [how much can we] grow topline revenue without accepting a degree of risk that puts the business in jeopardy? We have to find that sweet spot.”

Directors agree with regulators that the board needs to be more involved in risk appetite than in the past: “*We can be successful if we know how to measure, monitor, and get paid for the risks we are taking,*” asserted one summit participant. Yet participants report that calculating specific risk appetite limits, or tolerances, remains a significant challenge. As a director said at the summit, “*[Risk appetite] is a great term. Everyone uses it. But no one agrees on [what it means]. [Our] regulators think in superficial terms, like leverage ratios. [We’re] like two ships passing in the night. What does risk appetite mean?*”

While research participants agreed prior to the summit that “[risk appetite] is an art and not a science,” and “there is no one single answer for how to do it,” over the course of our research directors and executives shared several principles they have found helpful in improving their approaches to risk appetite definition.

Advice from directors on risk appetite

- **Incorporate a forward-looking view.** “Stress-testing [risk appetite assumptions] should help you fight the next war. It should focus [attention] on what could go wrong, not what went wrong the last time,” commented a research participant prior to the summit. Directors at the summit said they are pushing their respective risk organizations to understand more deeply *“what our prospective, over-the-cycle risks will be.”*
- **Draw on qualitative as well as quantitative analysis.** Prior to the summit, a research participant observed, “Everyone got seduced by what [could] be quantified, like VaR [value at risk] per unit of equity. But most of the really big risks are unquantifiable.” An executive noted, “We want the board focused on the softer elements [of risk appetite]: where are we on the risk spectrum? Are we being conservative or aggressive? How is management planning to turn the [risk] dial up or down?”
- **Promote extensive dialogue.** One director put it simply: “[Risk appetite] should not only be about people looking at a template or dashboard, but also having systematic discussions about ... what the numbers mean.” At the summit, a director shared a similar view: *“You can’t just listen to the CRO ... You need to have a dialogue with the risk takers.”*
- **Develop a carefully integrated approach.** Prior to the summit, an executive commented, “In many banks, [risk] is siloed. Metrics aren’t comparable and therefore have been difficult to aggregate.” However, FI leaders caution that in the absence of appropriate context, integrated risk tolerance data often does not provide enough information about the complexities of FI risks, especially those that are off-balance sheet (e.g., structured investment vehicles), and in fact may be misleading: “Value-at-risk numbers net risks down considerably. You can’t see who’s betting the bank.”
- **Match competencies with risk tolerances.** Summit participants agreed that *“risk appetite should be coordinated with the type of people that take the risk.”* In a conversation prior to the summit, an executive commented, “Our focus is as much on making sure we are taking a high enough risk in the areas where we have strong competencies ... as it is [on] reducing risk in areas where we are not as strong.”
- **Understand the limits of risk appetite calculations.** In pre-meeting conversations, an executive encouraged directors to remember that “it’s as important to understand what a model isn’t telling you as what it is telling you.” Another research participant observed, “Fiction of control is very dangerous. The biggest risk of all is if we start believing in the numbers 100% – [we need] a healthy dose of skepticism.”

Communicating risk appetite to external stakeholders

Several summit attendees noted a worrisome trend: *“There’s pressure [from regulators] to reduce risk to a number.”* As one research participant commented prior to the summit, “If we learned anything from the financial crisis, it’s that single measures of risk are not informative.”

Directors questioned how well regulators and other key stakeholders, such as institutional investors, understand the nuances of the risk-return frameworks underpinning management and board deliberations on risk appetite. *“Do they understand that it’s a risk-reward issue, not just about risks?”* asked one board member. Another participant reminded the group that while financial institutions are in the business of taking risks to make money, *“Regulators get no upside for taking risks, only downside. So they have to be in the business of preventing mistakes.”*

In this context, directors view with skepticism proposed requirements for increased disclosure on FI risks, such as the Walker Report’s recommendation that a report from the risk committee be formally included as a separate component of the firm’s annual report.⁹ As one director put it, *“I don’t know how we can communicate usefully on risk in more detail.”* In our pre-summit conversations, a former regulator expressed the same doubt: “I worry about the impact [of more] disclosures. You want a risk committee to [consider extreme scenarios], but reporting it publically could pose a problem.” Several summit participants suggested that more open dialogue with stakeholders, rather than more required reporting, would be a better approach: *“In the public domain, institutions reveal very little about how boards deal with risk,”* one director observed. *“[Maybe] shareholders and others [would] be better off understanding the dialogue behind our risk philosophy.”* Another board member suggested, *“Maybe we will have to meet with key institutional investors to discuss risk, rather than relying on boilerplate disclosures.”*

Defining the risk governance agenda

At the summit, one board leader commented, *“I am rethinking what we mean by risk ... There has been a distinct change of emphasis [in our boardroom discussions] ... [and] externally, regulators have higher expectations on directors to make macro risk judgments.”*

In discussions leading up to the summit meeting, directors said they intended to “substantially increase [our] level of engagement ... [in] risk oversight.” But many struggle to define what this means in practice. As one board member observed, “Regulators and commentators say ... ‘Every institution should adopt [its] own approach.’ That’s fine, but we need a place to start.”

A number of boards are examining and revising their risk agenda – their risk governance responsibilities and priorities – as a starting point. This is no small task today, when, as the Basel Committee notes, effective risk management “is not limited to credit, market, liquidity and operational risks, but incorporates *all* material risks. This includes reputational, legal and strategic risks, as well as risks that do not appear to be significant in isolation, but when combined with other risks could lead to material losses.”¹⁰

While boards must grapple with all of those risks, summit participants identified a number of risk governance priorities that are especially salient for board leaders and senior executives in the current environment:

- Ensuring capital allocation is appropriately risk weighted
- Probing the risks of new business activities
- Ensuring compensation arrangements are appropriately risk adjusted

Ensuring capital allocation is appropriately risk weighted

In a conversation before the summit, a board leader outlined a series of questions he believed directors need to ask their management teams with respect to capital allocation: “What’s our strategy for how [capital] is allocated? Is it in the right places to drive a good, risk-weighted return at the right risk appetite? What happens to us in a downturn? Which assets are liquid, and which are not? If we hit a crisis, how will we generate liquidity?”

At the summit, one director noted that while *“allocating capital is the CEO’s job,”* the board must actively question management’s assumptions to uncover any potentially faulty reasoning. One director described just such a situation: *“At [our company, management] wanted to make an investment, and we told them they didn’t have enough capital against the risk. They said, ‘If [we] put that capital against the risk, [we] wouldn’t want to be in the business.’ We said, ‘Exactly.’”*

Potential changes to liquidity and capital requirements are also pushing capital strategy higher on many audit and risk committee agendas. Supervisory authorities are working on enhancing international capital standards to mitigate tendencies toward procyclicality, a phenomenon whose dangers the financial crisis demonstrated dramatically. Mr. Rutledge noted that regulators will be asking FIs *“How well do you assess how much capital is needed to absorb losses, and still be able to operate as a going concern? How well do [banks] think through the action steps needed to restore capital under adversity?”*

However, FI leaders are concerned about regulators’ commitment to convergence of those standards: *“I was surprised to see the regulators’ behavior [during the] crisis,”* commented one director. *“The cross-border aspects of regulatory reform got lost ... Everyone was fighting for their own jurisdiction.”*

Members of the Institute of International Finance are extremely apprehensive about what they see as a loss of momentum toward harmonization of standards, and they are urging regulatory authorities to resist local “self-sufficiency or stand-alone approaches to liquidity regulation.”¹¹ A former regulator with whom we spoke prior to the summit predicted pessimistically, “Banks will face more pools of trapped capital in the future, because there will never be international agreement on liquidity requirements.”

Probing the risks of new business activities

The Basel Committee makes the following recommendation:

Before embarking on new activities or introducing products new to the institution, the board and senior management should identify and review the changes in firm-wide risks arising from these potential new products or activities, and ensure that the infrastructure and internal controls necessary to manage the related risks are in place.¹²

Our research conducted prior to the summit meeting uncovered support for this position. One executive observed, “A lot of the problems that the industry faced [in the financial crisis] were a result of insufficient thought and analysis given to the risks of products that were new or had morphed ... As a result, getting regular attention about [new-initiative] risks at the board level is very appropriate.” Another research participant recommended that FI directors place high priority on gaining “a thorough understanding of how something goes from idea generation all the way through to getting on the balance sheet.” A summit participant observed, *“Products like CDOs were lost in the system, deep in the lines of business. Firms didn’t stop to ask, ‘Have we back-tested our processes in light of these new products and risks?’”*

However, several summit participants also pointed out that *“[often] we can get lost in the definition of what’s new and what’s not new,”* since *“new products tend to be re-engineered old products.”* In an earlier conversation, a research participant expressed similar caution: “Pre-launch reviews of new businesses are not enough ... Failure to challenge the business models and risk/reward characteristics of established businesses has [also been] a problem.”

Rather than focusing on weighing the relative risks of new and established products or businesses, summit participants suggested boards should ask which businesses, based on their risk levels, the firm should be in at all. Describing the board’s involvement at Credit Suisse, Mr. Dougan said it examined *“whether a proposal by management is consistent with our strategy, [and] the risks attendant to that decision – market, operating, control, or reputation risk. We [also] have a process to review new businesses or new products with the board, but only when they are at a certain size or scale.”*

Summit participants cited businesses such as life insurance settlements, paycheck cash advances, and subprime mortgages as examples of businesses their boards had decided their firms should not enter due to the risks involved, including reputation risk. *“[We directors] should be able to put our hands up and say, ‘We are not getting in that business.’ Going forward, doing the right thing may become a more important factor in deciding what we will and will not do.”* Another board member agreed: *“Risk is about more than the metrics we look at and the products we deliver. It’s about doing the right things in the right way.”*

In conversations leading up to the summit, several directors expressed concern that extensive board or committee involvement in decisions related to new or rapidly growing businesses would slow down decision making to a potentially dangerous degree and would also put the board at risk of stepping into management’s domain. These directors suggested the board can enhance oversight of new-initiative risks by ensuring the chief risk officer has a seat at the table with

sufficient status to engage substantively in decision making: “It’s the board’s responsibility to ensure [the CRO] is in the room when [these] decisions and risk commitments are made.”

Ensuring compensation arrangements are appropriately risk adjusted

Compensation for FI executives has rocketed up the political agenda on both sides of the Atlantic in the last 12 to 18 months, raising complex questions and high emotions. Summit participants discussed compensation in a separate meeting session on October 6, 2009.

The risk dimension of compensation has been a central theme in the regulatory and political debate. Ms. Dewar of the FSA observed, “*Remuneration was encouraging a high amount of risk taking, based on cash [bonuses], and we are concerned that it hasn’t changed much.*” Other public-sector leaders have made it clear that scrutiny of compensation risk is here to stay and that they will take a more activist approach toward enforcement. In a pre-summit conversation, one regulator cautioned, “We consider [compensation] principles to be rules. So if brilliant people at a bank find a way to follow the rule, but violate the principle, we’ll still fine them.”

For their part, summit participants acknowledge that “*compensation is too high and leads to excessive risk taking.*” They believe that closely linked to the board’s responsibility for approving the firm’s risk appetite is its duty to ensure that financial incentives do not encourage risk-takers (e.g., traders) and senior management to take actions that exceed that appetite. In other words, boards must connect the dots between risk appetite, performance targets, and compensation policy.

At the summit, directors discussed a number of issues and challenges related to effectively coordinating the oversight of risk and reward:

- **Clarifying the distinction between structure and level of banker pay.** Summit participants noted the debate about FI compensation amongst some policymakers and in the press often conflates these two important issues, which must be treated separately.
- **Identifying practical approaches to risk-adjusting compensation.** Where policies were not already in place, board members report a number of changes under way in their institutions to ensure compensation arrangements are consistent with sound risk management.
- **Coping with the unpredictability of the regulatory environment.** Directors observed with concern that the unpredictable global regulatory environment has itself become a risk that FIs must handle – one that increases the likelihood that top talent will migrate to unregulated sectors of the financial world.

Compensation issues are covered in greater detail in the *ViewPoints* titled “Banker compensation at a crossroads.”¹³

Enhancing the board’s understanding of risks

Boards and committees are being pushed to ask tougher questions and to challenge management more actively on risk matters. This has stimulated them to think about how best to establish and maintain a high level of risk understanding in the boardroom: as one summit participant put it,

“How much knowledge does the board need to get us comfortable to stand behind management as they make key decisions?”

At the summit, directors identified several ways to help build the board’s risk knowledge:

- Improve the quality of risk communication between management and the board
- Establish an effective relationship with the chief risk officer
- Obtain independent perspectives on the firm’s risks

Improve the quality of risk communication between management and the board

A summit participant summed up the views of many peers in the room by stating, *“The quality of risk information is really a lifeline for the board.”* Another director wondered, *“Are we being told the right things [by management]? What kinds of questions should we be asking management?”*

Directors report that getting the right risk information has become even more challenging since the onset of the financial crisis because the volume and detail of management’s risk reports to the board have increased considerably. In a conversation before the summit, one director said, *“We’ve been inundated with data; [the committee] was completely underwater.”* This is partly due to a growing number of regulatory requirements for risk reporting, as one director observed: *“We keep asking management why a particular item is in there, and often they tell us it’s because of ... regulations. There’s [so much material]; we ask, ‘What do you want us to read [most]?’ and they say, ‘We can’t tell you.’”*

Some risk executives acknowledge that their own organizations have contributed to the avalanche of information: *“People can have the sense that ‘if I bring a lot of data to the table, I’ve done my job,’ but if you don’t distill the data, we haven’t done our job.”*

Several participants said they are working to overcome obstacles posed by siloed, inflexible information systems in order to provide the board with a holistic view of risks that synthesizes disparate risk data into actionable insight. The Senior Supervisors Group recently expressed this same concern, noting that:

Firms are constrained in their ability to effectively aggregate and monitor exposures across counterparties, businesses, risk strands, and other dimensions because of ineffective information technology and supporting infrastructure ... [Improvement projects] will require a significant dedication of funds, sponsorship, and commitment from the board and senior management.¹⁴

Enhancing risk reporting to the board

Summit conversations and prior research uncovered a range of ideas on how to manage the volume and quality of risk information flowing to the board:

- **Management should take the lead in distilling information.** In his comments at the summit, Mr. Dougan highlighted the difficulty of *“tak[ing] very complex businesses with complex issues and distilling [them] down to the key risks involved.”* In Mr. Dougan’s view,

“it’s management’s job to make it digestible [for the board].” One director agreed: *“Management has a responsibility to tell us what the [main] risk issues are.”* In the course of our research, risk executives shared approaches they are using to enhance risk communication to the board. See *“Techniques for improving management-board risk communication”* below.

- **The board needs to work with management to get the right balance of information.** In a conversation prior to the summit, one CRO, whose firm has a long-standing board-level risk committee, advised directors to take the time to “work with management on the form as well as the content of the risk information management is providing to them, [to] make sure [they] get maximum value ... It can take a few iterations to get it right.”
- **Risk information should not be distilled.** One board leader asserted that, for key committees at least, risk information should be provided to the board in unabridged form: *“At the risk committee at my bank, we decided a few years ago that we would get exactly the same information that was going to the management team. There shouldn’t be two sets of [risk data]. It was the best decision we took.”* Another participant noted, *“You can’t have a one-page document. The most succinct risk document we have is 40 pages long.”*

Techniques for improving management-board risk communication

Risk executives discussed the following techniques in pre-summit conversations:

- **Plain language.** Risk executives are striving to remove excessively technical language and risk jargon from committee communications. One said, “I push my team to put key points on one page, in plain [language].” Another CRO described his organization’s risk committee materials as “text heavy – more like case studies than big [slide] decks. It helps us to explain things to smart but non-technical directors.”
- **Consent agendas.** At one financial institution, the risk organization makes a clear distinction between presentation of requested updates or information required per regulatory mandate, “where there is little discussion beyond a short Q&A,” and more in-depth agenda items, where extensive discussion is needed. “Previously, every single [agenda item] had a long presentation along with it, and it took up tremendous amounts of time.”
- **Tailored communications.** Several CROs highlighted the benefits of segmenting information for different audiences. At one bank, committee reports are divided into a core, which contains all required and pertinent information, and more technical appendices, which contain additional detail for members with deep risk expertise.

Coordinating risk discussions at the board

Regardless of how risk reports to the board are structured, summit participants agreed that it is essential to coordinate discussion of the information among key committees and between committees and the full board. One director noted, *“I’m concerned about how we make sure we*

don't have gaps in what we are doing, or that we end up creating silos in [risk] oversight.” Mr. Dougan observed there is still “some ambiguity around where the risk committee ends and where the audit committee picks up. About half [our] sessions are joint sessions ... We try to err on the side of overlap, not allowing things to fall between the cracks.”

In addition to joint committee sessions, board leaders point to cross-committee memberships and open-invitation committee meetings as tools that help ensure adequate awareness about, and coordinated discussion of, key risk information without creating confusion about committee roles. And substance is more important than form: speaking prior to the summit about coordination between the risk and compensation committees, one research participant emphasized, “[It can’t] just [be] passive information exchange. [Committee members] need to steer each other toward what’s important and what can go wrong. They can’t just trade board papers and say they checked the box.”

In the end, each FI will make its own choices on allocation of risk responsibilities across committees, including whether or not to have a separately constituted risk committee. These choices will be influenced by firms’ specific operating context, including corporate and banking law, public company listing requirements, and sector regulations.¹⁵

Other Tapestry Networks research reveals that some boards are mapping current full-board and committee-level risk governance activities as an input to discussions about committee structure and information flows. The goal is to clarify the extent of existing workloads across committees, assess effectiveness, and identify potential opportunities for improvement.¹⁶

Establish an effective relationship with the chief risk officer

Board members and risk executives agree that an open line of communication between the CRO and the risk or audit committee (especially the chair) is the cornerstone of a productive working relationship with the risk organization, which, in turn, is essential for effective risk governance. Mr. Rutledge told directors that this relationship is also of interest to regulators: *“We will be looking at how the board engages with the CRO. How much and how often do they interact? Who sets the agenda – is it the CRO, or is it more of a two-way street?”*

Summit participants identified a number of issues on which they have been, or will be, engaging with chief risk executives. *“We [check with] our CRO about the stature of his organization: is it a serious function, or one that is merely tolerated?”* commented one director. Another stated, *“[Boards] need to understand the process that the CRO goes through to get [risk] information.”*

Several directors noted that they are encouraging their CRO to take a broader perspective on the firm’s risks – just as the board itself has been doing: *“We find the CRO spends too much time on past or current risks, and not enough on forward-looking risks. We want to know [more] about our prospective risks. Where are our exposures?”* Another director agreed, *“Risk functions in financial institutions tend to be focused on financial risks. What [they] look at less are regulatory risks and other policy risks such as cap and trade, the health care debate – these affect our clients [and] our investments, and thus create risks ... I am not sure if the CRO is really attuned to that.”*

For their part, CROs welcome the leadership of directors, especially committee chairs, in setting the agenda for risk discussions in the boardroom – otherwise, as several CROs commented at a recent gathering, “management [will be] managing the board.” These risk executives believe that in order to be successful at risk governance, directors should be “prepared to put in the work [to understand risk matters], seek out all possible sources of [risk information], and ... hold the CRO accountable.”

Obtain independent perspectives on the firm’s risks

Risk committee members and other board directors are increasingly interested in independent risk advice, to complement the information they receive from management. One director declared, “*We are in a new world ... We are seeking a greater degree of external advice on risk.*” While some research participants expressed skepticism about the use of outside risk advisers in conversations leading up to the summit, a larger number were in favor. One participant commented, “It’s amazing more boards don’t [have independent information on risks], but this will change in the future.” A chief risk executive declared, “A good management team shouldn’t mind an independent review of risks. It ought to help us get to a better conversation with the board.”

Board members reported various ways in which they are using outside advisers on risk matters:

- **Risk strategies.** Some directors are commissioning independent experts to “*kick the tires*” on risk assumptions and strategies or to provide perspectives on broad industry trends and changing risks in the market environment.
- **Risk management and governance structures.** Several FIs engage outside experts to evaluate board and management-level committee protocols as well as control and approval processes.
- **Risk reporting.** Some banks are seeking independent assessments of the quality of their risk reporting, including the aggregation of firmwide data, the selection of key risk metrics, and the quality and format of information reaching the board and senior levels of management.

FI leaders expect existing advisers will also be pressed for perspective on risk matters. “The external auditors should have an opinion [on risks],” asserted one chief executive in an interview earlier this year. A leading report on bank governance from the Netherlands recommended, “In order for both the Risk Committee ... and the external auditor to work effectively, a periodic exchange of information between the two is required, preferably twice a year.”¹⁷ Regulators and shareholders were also cited as valuable sources of outside insight on firm risks and culture. See [“Building a high-impact, effective board” for further discussion on boards’ access to external perspectives.](#)¹⁸

At the summit, directors observed that boards should not overlook employees as a source of fresh perspectives on risk matters: “*There are executives who can see around corners better than others. We need to spend time with them ... Their insights can be used as a platform [to help the board] probe management.*” Prior to the summit, research participants expressed similar views. One

executive noted, “The risk committee can ask for a special review of risks [from an external adviser] ... but I’d rather focus on making sure the risk committee is hearing the widest possible range of information from inside the company. That may mean [directors] need to get out to different sites and talk to [more] levels of management informally.”

Conclusion

Banks are in the business of taking risks, which means that risk matters will always be central to the board’s responsibilities, given its core role as adviser to the CEO and the management team. Regulators and investors have made it clear that they plan to hold directors much more accountable than in the past for their firms’ decisions and performance outcomes related to risk. These heightened expectations are occurring in parallel with boards’ risk governance responsibilities growing in depth, breadth, and complexity. However, as one summit participant noted, despite all the change, some things remain the same: *“The old ideas about risk may [have] changed, but the questions of how we make our business more profitable and how to move forward are still there.”*

Summit participants believe that discussion of a firm’s risks cannot be held separately from discussions of strategy, and similarly, that risk data and metrics, particularly those related to risk appetite, should not be viewed in isolation. Boards will be spending more time and digging deeper to understand the firm’s risks, working closely with the chief risk executive and drawing on internal as well as external sources of information. Above all, summit participants confirmed that FI board members are ready to take up the challenge and play a leadership role in shaping the future of risk governance in their institutions.

About this document

The Financial Institution Directors Summit brought together leading non-executive directors from North American and European financial institutions on October 5 and 6, 2009, to share perspectives on proposals for strengthening corporate governance. *ViewPoints* summarizes the proceedings of the summit. The peer-to-peer discussions were informed by prior interviews with over 120 FI directors, executives, regulators, investors, and other key stakeholders. Tapestry Networks conducted the research, orchestrated the summit, and prepared *ViewPoints*. Ernst & Young sponsored the research and summit as part of its deep, continuing commitment to board effectiveness and good governance.

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Endnotes

- ¹ This *ViewPoints* is part of a larger report which integrates participants' discussions at the Financial Institution Directors Summit with extensive research conducted over the past year. The full report is available at http://www.tapestrynetworks.com/documents/Tapestry_EY_BGLN_Nov09_fullreport.pdf.
- ² Senior Supervisors Group, *Observations on Risk Management Practices during the Recent Market Turbulence* (Senior Supervisors Group, 2008), 20. Available at http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf.
- ³ In this document, "director" refers to non-executive, non-employee board members on a firm's unitary or supervisory board.
- ⁴ On October 5 and 6, 2009, 18 board members from leading European and North American financial institutions met in New York to discuss the future of bank governance. They were joined for portions of the meeting by Mr. Brady Dougan, CEO, Credit Suisse Group; Ms. Sally Dewar, Managing Director, Risk, UK Financial Services Authority; Mr. Bill Rutledge, Executive Vice President, Bank Supervision Group, Federal Reserve Bank of New York; and Mr. Jim Turley, Chairman and CEO, Ernst & Young.
- ⁵ The *ViewPoints* reflects the use of a modified version of the Chatham House Rule whereby names of members, guests, and company affiliations are a matter of public record, but comments made by members before and during meetings are not attributed to individuals or corporations. However, Messrs. Dougan and Rutledge and Ms. Dewar have given permission for their remarks to be attributed. Comments by these guests and summit participants are shown in italics.
- ⁶ Tapestry Networks has published two briefing notes under the title *Shaping bank governance in a new era*. The first, subtitled *Enhanced oversight versus radical reform*, was published in June 2009. The second, subtitled *A revised compact with management and shareholders*, was published in August 2009. Both are available at http://www.tapestrynetworks.com/networks/net_bank.html.
- ⁷ J. Chris Karow, "Discovering Risk Appetite," *Crosscurrents: The magazine for financial services executives*, no. 31 (Fall 2007). Available at [http://www.ey.com/Publication/vwLUAssets/CrossCurrents_Fall_2007_-_Discovering_Risk_Appetite/\\$FILE/Industry_Insurance_CrossCurrentsFall07RiskAppetite.pdf](http://www.ey.com/Publication/vwLUAssets/CrossCurrents_Fall_2007_-_Discovering_Risk_Appetite/$FILE/Industry_Insurance_CrossCurrentsFall07RiskAppetite.pdf).
- ⁸ Senior Supervisors Group, *Risk Management Lessons from the Global Banking Crisis of 2008* (Senior Supervisors Group, 2009), 23. Available at http://www.newyorkfed.org/newsevents/news/banking/2009/SSG_report.pdf.
- ⁹ David Walker, *A review of corporate governance in UK banks and other financial industry entities* (London: HM Treasury, 2009), 89. Available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf.
- ¹⁰ Basel Committee on Banking Supervision, *Proposed enhancements to the Basel II framework* (Basel: Basel Committee on Banking Supervision, 2009), 13. Available at <http://www.bis.org/publ/bcbs150.pdf?noframes=>. Emphasis in the original.
- ¹¹ Institute of International Finance, *Restoring Confidence, Creating Resilience: An Industry Perspective on the Future of International Financial Regulation and the Search for Stability* (Washington, DC: Institute of International Finance, 2009), 51. Available at <http://www.iif.com/press/press+76.php>.
- ¹² Basel Committee on Banking Supervision, *Proposed enhancements to the Basel II framework*, 13.
- ¹³ Tapestry Networks, "Banker compensation at a crossroads," *ViewPoints*, November 2009. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_BGLN_Nov09_View3.pdf.
- ¹⁴ Senior Supervisors, Group, *Risk Management Lessons from the Global Banking Crisis of 2008*, 26.
- ¹⁵ To take just one example, research participants operating within the supervisory board structure may be less able than participants on unitary boards to increase their level of engagement and oversight, particularly in critical areas such as risk governance. This constraint may be lifting in some countries, however. In a recent revision to its minimum requirements for risk management, the German Federal Financial Supervisory Authority (BaFin) opened the door for supervisory boards to get more involved in risk matters, including granting them the right to request risk information directly from the internal audit organization. See Federal Financial Supervisory Authority, "New Minimum Requirements for Risk Management (MaRisk): BaFin implements international risk management standards," press release, August 2009. Available at http://www.bafin.de/clin_152/nn_720788/SharedDocs/Mitteilungen/EN/2009/pm_090814_marisk_new.html.
- ¹⁶ Ernst & Young, "A new landscape for risk management and oversight: considerations for audit committees," *InSights*, April 3, 2009, 8. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_Insights_Apr09.pdf.
- ¹⁷ Advisory Committee on the Future of Banks in the Netherlands, *Restoring trust* (Advisory Committee on the Future of Banks in the Netherlands, 2009), 16. Available at <http://www.nvb.nl/scrivo/asset.php?id=290353>.
- ¹⁸ Tapestry Networks, "Building a high-impact, effective board," *ViewPoints*, November 2009. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_BGLN_Nov09_View4.pdf.

FI Directors Summit participants

Board director participants:

- Jalynn H. Bennett, Corporate Governance Committee Chair, Audit Committee Member, CIBC
- Roy J. Bostock, Nominating and Governance Committee Member, Morgan Stanley
- Sir Richard Broadbent, Deputy Chairman, Risk Committee Chair, Corporate Governance and Nominations Committee Member, HR and Remuneration Committee Chair, Barclays
- Dr. Karl-Gerhard Eick, Audit Committee Chair, Deutsche Bank
- Laban P. Jackson, Jr., Audit Committee Chair, JPMorgan Chase
- Olivia F. Kirtley, Audit Committee Chair, Governance Committee Member, Executive Committee Member, U.S. Bancorp
- Jean Lanier, Audit Committee Member, Credit Suisse
- Nicholas D. Le Pan, Risk Management Committee Member, CIBC
- Brian M. Levitt, Risk Committee Member, TD Bank
- Donald T. Nicolaisen, Audit Committee Member, Compensation, Management Development and Succession Committee Member, Morgan Stanley
- Charles H. Noski, Audit Committee Chair, Morgan Stanley
- William G. Parrett, Audit Committee Chair, UBS
- Arthur F. Ryan, Nominations Committee Member, RBS
- Anthony M. Santomero, Audit and Risk Committee Member, Public Affairs Committee Member, Citigroup
- David Sidwell, Risk Committee Chair, Strategy Committee Member, UBS
- Patrick T. Stokes, Risk Management Committee Chair, Compensation and Human Resources Committee Member, Executive Committee Member, U.S. Bancorp
- John M. Thompson, Chairman, Corporate Governance Committee Chair, Management Resources Committee Member, TD Bank
- Anton van Rossum, Risk Committee Member, Credit Suisse

Ernst & Young participants:

- Carmine DiSibio, Vice Chair and Managing Partner, Financial Services
- Radwan Hoteit, Leader and Market Coordinator, Banking and Capital Markets, EMEIA Financial Services
- Thomas P. McGrath, Managing Partner, EMEIA Financial Services
- Lawrence Prybylski, Global Practice Leader, Financial Services Risk Management
- William Schlich, Industry Leader, Banking and Capital Markets, Financial Services
- James S. Turley, Global CEO and Chairman
- Donald T. Vangel, Advisor, Regulatory Affairs