

Bank Governance Leadership Network Meeting note

August 1, 2011

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Taking risk governance from satisfactory to strong

Last year, participants in the Bank Governance Leadership Network (BGLN) identified several areas in risk governance where they had made progress and several others in which improvement opportunities remained.¹ This year, the network hosted several discussions among non-executive directors (especially risk chairs), chief risk officers (CROs) and risk regulators with the intention of accelerating improvements in both risk governance and oversight.

Tapestry Networks and Ernst & Young held meetings in London and New York on June 27, and July 13, 2011, respectively, to enable this discussion. This meeting note² provides a brief overview of the discussions, which focused primarily on four themes:

- Clarifying expectations of the board's risk committee
- Refining risk appetite and establishing a supportive risk culture
- Improving risk reporting and the underlying information technology (IT) systems
- Establishing an industry-wide conversation on emerging risks

Clarifying expectations of the board's risk committee

External stakeholders have ratcheted up expectations of bank boards and have focused particular attention on risk committees. Most participants agreed that the risk committee has proven to be, as one director put it, *"a very important part of the control network of the bank, because it improves the focus and dialogue on risk."* But do stakeholders fully understand or agree on the risk committee's role?

At the New York meeting, most directors agreed that risk committees *"provide advice, oversight and challenge."* They challenge by *"digging deeper,"* where necessary, and by *"cross examining,"* which in turn helps *"set the [risk] agenda."* The committee helps set the tone for risk, empowering the CRO and the risk team, and reinforcing the importance of risk throughout the organization. Knowing issues will be reviewed by the committee, sometimes several times, *"makes risk professionals work harder."* Those at the London meeting agreed that the board and risk committee should *"ensure the right culture is in place, that the risk appetite is right and the right stress testing is done ... that the caliber of the risk professionals and risk infrastructure is appropriate ... and that the non-executive directors provide the right support and investment for risk management."* Supervisors present at the meeting generally concurred.

Non-executive directors observed that regulatory guidance often blurs the roles of the board and management (e.g., by making statements that begin, "The board and management shall approve...") and pointed out that on-site bank examiners will frequently ask, *"Did [a given policy or procedure] get approved*

¹ See Bank Governance Leadership Network, ["Strengthening the board-management dialogue on risk and strategy,"](#) *ViewPoints*, November 15, 2010.

² This meeting note reflects the network's use of a modified version of the Chatham House rule whereby comments made during conversations with participants are not attributed to individuals or organizations. These conversations included interviews with chief risk officers from major global banks as well as risk chairs and committee members, leading regulators, and subject-matter experts. Quotes in italics are drawn directly from those conversations.

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by the board?” The result is that the risk committee’s attention is taken up by details and minor procedural matters rather than the big picture. One supervisor suggested that perhaps banks are overly anxious about supervisory requirements: *“There is a misunderstanding [on the part of risk committee members] of what ... we expect.”* They, too, view the risk committee’s overall role as being one of oversight.

Non-executive directors noted that when the risk committee does approve something (e.g., a stress test or a model validation), the understanding is that it is mainly approving the quality of the associated governance processes. Supervisors generally agreed, but stated that the committee should also *“sanity check”* the output, for example, the magnitude of any capital needs arising from stress tests.

Refining risk appetite and establishing a supportive risk culture

During the past 18 months, banks have invested heavily in developing and promulgating risk appetite statements. While some have criticized risk appetite as a buzzword, most practitioners have come to agree that the concept has enabled more robust board/management discussions of risk tolerance and strategy.

Several CROs interviewed before the meetings asked, *“Just how far do you go with a risk appetite statement?”* Few were confident that they have achieved a comprehensive, integrated risk appetite statement. Directors at the meetings in London and New York varied in their positions, with some feeling the need for more technical definitions – for example, of *“stressed VaR [value at risk]”* – while others leaned toward simpler, practical frameworks: *“[The risk appetite statement] has to be such that the non-executive directors could talk about it confidently in front of regulators around the world.”* All of those present at the meetings agreed that there is still work to do on *“embedding”* and communicating the organization’s risk appetite and on incorporating operational and reputational risk metrics appropriately.

Meeting participants diverged sizably on how much progress has been made to date. Non-executive directors and CROs said they are progressing well on their risk journey, despite taking varying approaches to their risk appetite statements and broadly agreeing on a number of areas where work remains. Supervisors had a less sunny assessment, identifying similar areas for improvement, but also questioning the bank’s ability to properly aggregate risk at the top of the house. One noted, *“Only one of the top ... banks [we supervise] has a good handle on their risk appetite. Most want to be shown what success looks like. Many are floundering.”* Several CROs and directors felt the floundering is because *“regulators have not been clear or consistent about what ‘strong’ means.”* *“The goalposts keep on moving,”* one asserted.

Discussions on risk appetite at both meetings led naturally to the importance of a strong risk culture. Everyone agreed that it is relatively easy to identify a bad culture, but developing tangible metrics is more challenging. One CRO observed, *“While one cannot measure culture that well, one can measure people’s behaviors.”* Furthermore, because large banks have *“very heterogeneous”* workforces, forging a single culture is difficult, if not impossible. Indeed, participating banks are so large that one has to assume that there will be mistakes in the areas of risk and controls at some point. The challenge, therefore, is finding ways to evaluate whether actual behaviors on the ground are consistent with a broader set of agreed-upon, high-level values. An important dimension is *“the manner in which we encourage colleagues to raise and highlight concerns, knowing there will always be mistakes, and come down heavy on those that hide*

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problems.” Sanctions have to be used and be seen as being used without discouraging openness or the appropriate escalation of errors or issues when they arise.

Participants at both meetings suggested several metrics or factors that indicate the quality of the risk culture, including the number of, and reasons for, limits being broken, the number of control problems internal audit identifies or management self-reports, general awareness of risk issues (e.g., information security) and the manner in which risk and control matters and adherence to ethical standards are incorporated into the bank’s ongoing evaluation and compensation systems.

Non-executive directors felt that, because of their enhanced on-site presence, regulators are well placed to monitor behaviors deep in the organization, as are external auditors, and they urged regulators to share their perspectives on the *“tone at the bottom”* with the banks. Non-executive directors, by contrast, are better placed to monitor and evaluate tone at the top, given their more significant exposure to senior management. Incorporating input from both perspectives will improve internal and external assessments of the overall institutional culture.

Improving risk reporting and the underlying information technology (IT) systems

Participants said the pace and scale of the information requests coming from supervisors is causing significant concern across the industry. Multiple regulators in some jurisdictions and an increasing number of international organizations contribute to the demand. Everyone present agreed that risk professionals are in danger of being so overwhelmed by requests that they don’t pay enough attention to risk identification. Some participants suggested that the volume of information supervisors are likely to receive as a result of their requests may cause such an overload that the supervisors, too, will no longer be able to effectively analyze the data to spot key risks. (See below for more on enabling more discussion on emerging risks.)

Financial institutions, meanwhile, are investing heavily in technology to collect and disseminate the requested information to boards, risk committees and regulators. The challenges are great: data must be pulled from across the organization and often must be pieced together from legacy systems, which greatly increases the potential for errors. The increasing threat of cyber attacks complicates the process further. A risk chair stated simply, *“If we don’t get our acts together on cyber security, we’re dead.”* In this context, at both meetings, there was a sense that *“complaining about [supervisors’ information] requests is like complaining about the weather,”* and that the common goal among firms and regulators should be to have *“grown-up conversations,”* whether the topic be agreeing common definitions and terms that will be used across the industry, or specific information requests made of firms.

Establishing an industry-wide conversation on emerging risks

Participants agreed that directors, CROs and regulators alike are expected to be able to spot emerging risks, but the discourse between banks and regulators on these risks remains suboptimal. Participants broadly agreed with an observation made prior to the meetings: *“This is an area where we all still have work to do. We don’t do enough to focus on emerging macroeconomic risks.”* They also worried that without continuous pressure, and as the economic environment improves, bankers may have short memories and

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regress to problematic behaviors. Many cited indicators such as the reemergence of covenant-lite loans, higher loan-to-value mortgages, and the growth of syndicated loans.

Meeting participants were eager to develop more routine mechanisms through which to discuss emerging risks across the industry. Directors and CROs would welcome the opportunity to discuss supervisors' views on emerging risks, especially macroeconomic risks, and especially when the supervisors have had time to digest and evaluate relevant data. Likewise, supervisors would like to discuss banks' views of emerging risks. Everyone likely has a different list of "top ten external risks," and discussing the lists and reasons for the differences would benefit everyone. The challenge is to find a neutral environment in which to have these discussions, protect confidential information and avoid unintended consequences.

Ultimately, banks and regulators have to find ways to work together, on a firm-by-firm and industry basis, to rebuild trust. The financial crisis greatly strained relationships across the industry and between banks and their regulators. In this summer's meetings, participants reaffirmed their strong desire to find practical ways to work more effectively together to build strong, sustainable banks and capital markets, with strong and enhanced risk governance central to this goal.

About this document

The Bank Governance Leadership Network (BGLN) provides a unique forum in which key non-executive directors of major global banks can develop and share perspectives on the defining issues of the new banking environment, in conjunction with key internal and external constituencies. The network is convened by Tapestry Networks with the sponsorship and support of Ernst & Young.

ViewPoints aims to capture the essence of the BGLN discussion and associated research; it is produced by Tapestry Networks. Anyone who receives *ViewPoints* is encouraged to share it with those in their own network. The more board members, senior management, advisers, and stakeholders who become engaged in this dialogue, the more value will be created for all.

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Appendix: Meeting attendees and interviewees

June 27 meeting attendees

- Michael Brosnan, Senior Deputy Comptroller, Office of the Comptroller of the Currency
- John Coombe, Audit Committee Chair, Risk Committee Member, HSBC
- Sir Howard Davies, Risk Committee Chair, Morgan Stanley
- Sally Dewar, Managing Director, JPMorgan Chase
- Pieter Emmen, Director, Group Risk Management, Rabobank
- Karl Guha, Group Chief Risk Officer, UniCredit
- Marinus Minderhoud, Audit, Compliance and Risk Committee Chair, Rabobank
- Marc Moses, Group Chief Risk Officer, HSBC
- Lyndon Nelson, Managing Director, Risk, Financial Services Authority
- David Roberts, Risk Committee Chair, Lloyds Banking Group
- Tom Woods, Chief Risk Officer, CIBC

July 13 meeting attendees

- Michael Alix, Senior Vice President, Federal Reserve Bank of New York
- Mark Chauvin, Chief Risk Officer, TD Bank
- Nicholas Donofrio, Risk Committee Chair, BNY Mellon
- Morten Friis, Chief Risk Officer, Royal Bank of Canada
- Gaetano Geretto, Senior Director, Office of the Superintendent of Financial Institutions
- Michael Loughlin, Chief Risk Officer, Wells Fargo
- Harold MacKay, Risk Committee Chair, TD Bank

- Maureen Miskovic, Group Chief Risk Officer, UBS
- Brian Rogan, Chief Risk Officer, BNY Mellon

Other interviewees

The following individuals also contributed directly to preparation for these risk meetings:

- Stephen Allen, Chief Risk Officer, Macquarie
- Susan Bies, Risk Committee Member, Bank of America
- David Booth, Risk Committee Chair, Barclays
- Nathan Bostock, Chief Risk Officer, RBS
- Mark Branson, Head of the Banks Division, FINMA
- Sir. Sandy Crombie, Senior Independent Director, Risk Committee Member, RBS
- Tobias Guldemann, Chief Risk Officer, Credit Suisse
- Richard Hidy, Chief Risk Officer, U.S. Bancorp
- Axel Lehmann, Risk Committee Member, UBS, and Chief Risk Officer, Zurich Financial Services
- Nicholas Le Pan, Risk Committee Chair, CIBC
- Sir Callum McCarthy, Risk Committee Member, ICBC
- Benoît Ottenwaelter, Chief Risk Officer, Société Générale
- Ted Price, Assistant Superintendent, Office of the Superintendent of Financial Institutions
- Catherine Rein, Audit Committee Chair, BNY Mellon
- Greg Targett, Chief Risk Officer, Westpac
- Koos Timmermans, Chief Risk Officer, ING