THE ROLE OF THE BOARD IN RISK MANAGEMENT

PERSPECTIVES FOR INDIAN FINANCIAL INSTITUTIONS

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INTRODUCTION

The global financial crisis has exposed deep flaws in the governance of many Western financial institutions. Chief among these flaws was the inadequacy of Boards’ understanding and control of risks taken by management. The result was that Boards failed to limit exposure to complex or leveraged lending, allowed their institutions to operate with a material liquidity shortfall and, in some cases, were undermined by acquisition-hungry CEOs.

These failures derived from structural defects. Boards often lacked members with risk management expertise and received incomplete and out-of-date information about the risks being taken or the risks they were exposed to. Furthermore, they played little or no formal role in ensuring that strategic decisions took account of capital and liquidity consumption.

Since the crisis, investors and regulators are paying close attention to the role of Boards in risk management. It has become standard practice among international financial institutions to establish a Board Risk Committee, separate from the Board Audit Committee or Board Credit Committee, to bring the required focus and attention to Boards’ risk oversight role.

Here in India, the impact of the crisis has been less dramatic and therefore many observers have perceived the need to re-evaluate the Board’s engagement on risk issues to be less urgent. One sign that Indian Boards are increasing their focus on risk is that in the last three years, Board Risk Committees have been established at nearly all institutions that didn’t have them previously.

However, establishing a Board Risk Committee is not enough on its own. The Committee must also function properly to enhance corporate governance and make valuable contributions to the prudent management of the institution. Indian Boards too often lack adequate risk expertise and tools to provide themselves with a clear understanding of the current and future risk profile of their institutions.

In this paper, we describe the roles that Boards of financial institutions need to play to fulfill their responsibility of providing optimal risk oversight in their organizations. We conclude with a list of initiatives they need to undertake in preparation for their expanding role.
THE BOARD’S ROLE IN RISK MANAGEMENT

Boards have the ultimate responsibility for overseeing risk-taking in their institutions. To fulfill this responsibility, there are four key roles that a Board must play:

• **SET THE ORGANIZATION’S RISK APPETITE** Financial institutions are in the business of buying, selling and holding financial risk. Setting a risk appetite – i.e. specifying the amount and types of risk that an institution is willing to undertake in pursuit of a desired financial performance – that incorporates the objectives of multiple stakeholders (shareholders, rating agencies, regulators, etc.) is a core responsibility for the Board. The Board’s responsibilities go beyond setting and signing-off on the risk appetite. It must also ensure that risk appetite has the required “bite” in the organization, making it part of important decision-making processes, including M&A, planning and budgeting, target setting, performance management and product approvals.

• **OVERSEE GOVERNANCE OF RISK-TAKING IN THE ORGANIZATION** The Board is tasked with overseeing the robust governance of risk-taking throughout the institution. This is accomplished through oversight of the overall control framework, monitoring the evolving and projected risk profile against the stated risk appetite and ensuring a strong “risk culture” in the organization.

• **ENSURE APPROPRIATE INCLUSION OF RISK IN COMPENSATION POLICY** The Board should ensure that compensation practices are properly aligned with prudent risk-taking. As per the guidelines of the RBI, compensation mechanisms should be adjusted for all types of risks, and compensation outcomes should be symmetric with risk outcomes. In addition, payout schedules must be sensitive to the “time horizon” of risks. Boards typically direct the Board Risk Committee and Remuneration Committee to work together to ensure that incentive schemes do not encourage poor risk-return trade-offs.

• **OVERSEE AND SIGN-OFF RISK RELATED DISCLOSURES** The Board is responsible for overseeing and signing off risk-related disclosures to investors, customers and regulators. These disclosures should provide external parties with a clear and accurate account of the institution’s current and projected risk appetite, profile and governance.
IMPERATIVES FOR INDIAN FINANCIAL INSTITUTION BOARDS

To prepare themselves for this expanding oversight role, we see five imperatives for the Boards of Indian financial institutions.

1. CREATE A BOARD RISK COMMITTEE WITH THE RIGHT MANDATE AND EXPERTISE

Most large Indian financial institutions have established Board-level risk committees in the wake of global financial crisis. Any institution that does not have a separate Board Risk Committee would well be advised to create one as soon as possible. This committee needs to be separate from the Board Audit Committee or Board Credit Committee and its mandate must be clearly and concisely documented and communicated across the organization.

The members of Board Risk Committee must have sufficient expertise in financial services and risk management to effectively oversee the institution’s risk taking. To ensure the necessary expertise, members of the committee should be chosen from relevant and diverse backgrounds and should be provided with training on an on-going basis.

2. SET RISK APPETITE FOR THE INSTITUTION

Setting the risk appetite starts with a top-of-house articulation of risk strategy which is endorsed by the Board. This is articulated as pre-set limits and triggers that can be used for ongoing monitoring of the risk profile of the organization. As indicated in the exhibit below, a formal risk appetite statement enables each business to optimize risk-return decisions in a manner consistent with its stakeholders’ expectations using a combination of financial and non-financial risk measures.
While the Board has ultimate responsibility for setting the risk appetite, most institutions task management (usually coordinated by Risk) with drafting a proposed risk appetite under the review and guidance of the Board Risk Committee.

3. MAKE RISK APPETITE A PART OF ALL STRATEGIC DECISIONS

Risk appetite statements are effective only if they are used to guide decision-making in the institution. The Board should ensure that risk appetite is part of important decision-making processes including M&A, planning and budgeting, target setting, performance management and new product approvals. Risk appetite should also be considered in the compensation process.

4. INSIST ON REPORTS THAT PROVIDE CLEAR AND TIMELY RISK INFORMATION

The Board and the Board Risk Committee need timely, accurate and comprehensive but concise reports on the current and projected risk profile in relation to stated risk appetite targets. The Board must ensure that the institution has effective risk reporting infrastructure and processes. An effective risk information and reporting dashboard is:

- **TAILORED TO A NON-EXPERT AUDIENCE** Reports should not be overtly technical and should be suitable for a non-expert audience in terms of style and methods of presentation.
• **ALIGNED TO THE RISK APPETITE** Reports should be aligned to the risk appetite. They should state the risk profile of the institution using the dimensions of the risk appetite statement, highlighting potential or actual breaches. Since best practice risk appetite statements employ forward looking measures of risk under a range of scenarios, reports should be backed by robust, institution-wide stress testing regimes.

• **COMPREHENSIVE** Reports should cover all the major risks to which the institution is exposed. Often the reports exclude risks that span risk-types or businesses, those that cannot easily be quantified and those that originate in back office or shared services.

• **CONCISE** Risk reports should cover headline issues and the most significant risks in single concise report. Separate reports from Compliance, Legal, Risk and Financial Controlling should be avoided as this creates too much (and overlapping) material for time-constrained Board or Committee members to review and absorb.

• **TIMELY AND FLEXIBLE** Reports should be up-to-date, thereby allowing the Board to react in a timely manner. They should also be flexible so that they can be analyzed or changed, for example, by drilling down into an area of concern.

5. **ESTABLISH AN INDEPENDENT AND EFFECTIVE “SECOND LINE OF DEFENSE”**

As a non-executive Committee, the Board Risk Committee must depend on the institution’s executives, especially the Risk and Control functions, to implement its guidance. This “second line of defense” must be empowered and independent of both active risk-taking in the business and of the Audit function, which comprises the “third line” of defense.

Boards of Indian financial institutions should review the level of authority and independence provided to the heads of these control functions, in particular to the head of risk management. The global trend is increasingly to have the head of risk be a C-level executive with a seat on the executive committee, reporting to the CEO and with direct access to the Board Risk Committee.

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Boards find themselves today at an inflection point. The industry is becoming more complex and competitive and supervisors are expecting more ownership for risk issues to rest with financial institutions themselves. To avoid the missteps of Western institutions, Indian Board members have no choice but step up to the new challenges and build more robust oversight mechanisms.
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