OLIVER WYMAN

Financial Services

New Year's Resolutions for the Board Risk Committee

The financial crisis exposed flaws in the governance of Financial Institutions. Many Boards did not understand or control risks taken by the executive. They failed to limit exposure to complex or leveraged lending, allowed their banks to operate with a material liquidity shortfall, and in some cases were undermined by acquisition-hungry CEOs.

This poor performance was caused by structural defects. Many Boards lacked members with risk management expertise and a committee dedicated to risk management. They received incomplete and out of date information on risk and return. And they played little or no formal role in ensuring that strategic decisions took account of capital and liquidity consumption.

The Basel Committee's Principles for enhancing corporate governance, (published in October) recommend that these failings be addressed by establishing a Board-level risk committee. It should be *"responsible for advising the board on the bank's overall current and future risk tolerance/appetite and strategy, and for overseeing senior management's implementation of that strategy. This should include strategies for capital and liquidity management, as well as for credit, market, operational, compliance, reputational and other risks of the bank"*. This has been echoed in several local regulations, including the UK Walker Review, the Central Bank of Ireland Corporate Governance Code and the Netherlands' Maas Review.

Many institutions have therefore established a Board Risk Committee, separate from the Board Audit Committee or Board Credit Committee. Of 27 major European banks examined by Oliver Wyman, seventeen now have a separate Board-level Risk Committee; seven of which were established within the last three years[1].

Merely having a Board Risk Committee in place is, however, not enough; it must also function properly, so as to positively enhance corporate governance and be seen as making valuable and relevant contributions to the running of the bank.

At this time of year, it is traditional to take stock and make resolutions for the year ahead. This article proposes some resolutions for consideration by Board Risk Committee Chairmen and members.

1 Source: Company websites and Annual Reports as at 1st November 2010

Resolution #1: We will set clear objectives for our Board Risk Committee

Board Risk Committees can be effective only if they have clear objectives, which should include the following:

1. The Board Risk Committee must **specify the institution's risk appetite and ensure that is it used in strategic decision-making.** As recommended by Basel, Walker and others, the Committee must ensure that the risks taken by the institution are in line with Board and investor expectations. It should ensure that business processes, such as planning, performance management and product approvals, take account of risk.

2. The Board Risk Committee must **work with the Remuneration Committee to ensure that risk has been adequately captured within the institution's compensation framework.** The Board Risk Committee should provide expert guidance to the Remuneration Committee to ensure that incentive schemes are risk-adjusted and do not encourage poor risk-return trade-offs.

3. The Board Risk Committee must **oversee the robust and comprehensive governance of risk-taking throughout the institution,** through oversight of the overall controls framework; monitoring the evolving and projected risk profile, and creating the "risk culture" of the institution. This encompasses not only risk management but relevant parts of compliance, financial controlling and other "second line of defence" functions.

4. The Board Risk Committee is **responsible for overseeing and signing-off risk-related disclosures** to investors, customers and regulators via the Board Risk Committee Report. This should provide external parties with a clear and accurate account of the institution's current and projected risk appetite, profile and governance.

Resolution #2: We will make sure our Board Risk Committee is up to the job

The Board Risk Committee will be able to oversee the institution's risk taking only if its membership includes experts in financial services and risk management. Strikingly, of the 17 institutions in our survey identified to have a Board Risk Committee, only five had members with financial services risk management experience listed on their CVs.

The topics addressed by this group will sometimes be technical, typically reflecting either product complexity or sophisticated risk management methods. Committee members must be able to question and challenge managers who are experts in their field. Some members may require training to ensure their technical knowledge remains sufficiently deep and up-to-date.

The culture and dynamics of the group must support open and straightforward debate. Committee members must feel comfortable asking questions, challenging management and each other, and requesting clarification when necessary. The Chair of the Committee should be a senior non-executive who can play a pivotal role in fostering such a constructive environment.

Finally, the Committee must be effective in covering the major risk topics and overseeing mitigation. The Chair needs to be capable of driving consensus on sensitive points, and running a tight agenda with very focused sessions looking at the major current and forward-looking risk issues, if needs be at the cost of reducing airtime for 'box-ticking' presentations.

Resolution #3: We will provide our Board Risk Committee with the right mandate

The mandate of the Board Risk Committee must be clearly and concisely documented and communicated widely across the organisation. The Committee's role in business processes and decisions, such as strategic planning, risk appetite setting, performance management and M&A, must be explicit. It is especially important to clarify the role of the Risk Committee in relation to the Audit and Remuneration Committees, and the communications and interactions between these committees. The Chair of the Audit Committee is a member of the Risk Committee in nine of the seventeen institutions with Risk Committees in our study.

Resolution #4: Our risk appetite framework will have "bite"

Many institutions that struggled or failed during the recent crisis had risk appetite statements. However, such statements are effective only if they affect decision-making in the institution.

The Committee's responsibilities include not only overseeing and signing-off the risk appetite statement but also ensuring that it is appropriately cascaded by management into the organisation's limits and delegated authority framework. The Board Risk Committee must receive assurance of adherence through regular reporting and stress test results, to gain comfort that the institution will remain within appetite, even under challenging scenarios, and oversee the creation and implementation of mitigation plans when it appears likely that risk appetite will be breached.

The Board Risk Committee should ensure that risk appetite is part of important decision-making processes, including planning and budgeting, target setting, performance management and product approvals.

Resolution #5: The Board Risk Committee will have adequate information about the risk profile of the institution

A Board Risk Committee needs timely, accurate, comprehensive reports on the current and projected risks that the institution is exposed to, including under stressed conditions. However, the reports received by Board Risk Committees often fall short:

- **Too long and detailed.** Reports often contain too much material for time-constrained Committee members to review and absorb, obscuring headline issues and the most significant risks. This is a particular problem when Compliance, Legal, Risk and Financial Controlling report separately.
- **Too technical.** Some metrics and methods of presentation require technical expertise beyond that of the non-executive Committee members. This is especially problematic when metrics and methods are inconsistent across different parts of the organisation.
- **Too late or inaccurate.** Poor systems or production processes mean that reports cannot be produced in a timely fashion, contain errors or cannot easily be changed or analysed (the Board cannot "drill-down" into particular areas of concern).
- **Not comprehensive.** Reports do not cover all of the major risks to which the institution is exposed, for example, they exclude risks that go across risk-types or businesses, those that cannot easily be quantified and those that originate in back office or shared services.
- **Not business aligned.** Reported risks are not aligned with assignable P&L impacts, making it difficult to compare risk profiles and risk-return across businesses and peers.

Resolution #6: Our Board Risk Committee will have access to the Risk and Control functions

Committee members should have direct and unrestricted access to the CRO, CFO and other senior control function staff, who should regularly attend Committee meetings and be approachable between meetings. At just over half of the institutions we surveyed, the Board Risk Committee Terms of Reference explicitly require or recommend the attendance of the CRO. A slightly lower number require or recommend the attendance of the CFO.

Resolution #7: Our Board Risk Committee will make effective use of external advice

As noted by both the Basel Committee Principles and the UK Walker Review, Board Risk Committees benefit from selective externally provided advice. Independent expert advisors can provide insights into market conditions, emerging international trends and evolution in best risk management practices, helping the Committee to regularly upgrade its fact-base and challenge its own and the institution's "conventional wisdom".

Resolution #8: An independent and effective "second line of defence" will implement the recommendations of the Board Risk Committee

As a non-executive Committee, the Board Risk Committee depends on the institution's executives, and in particular the Risk and Control functions, to execute and implement its guidance, in accordance with the policies and appetite that it signs off on.

The control functions must be independent of both the active risk-taking in the business and of the Audit function in the "third line". They must be resourced with skilled and experienced staff and with adequate systems.

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Simply establishing a Board Risk Committee is an important step towards improving risk governance and ensuring that strategic decisions take proper account of risk. But it is only the first step. The next steps are to ensure that the Board Risk Committee has the members, mandate, information and recognition that allow it to do its job. Live up to our suggested resolutions for 2011 and the Committee will be well on its way to enhancing the trust of investors and regulators in risk management at your institution.

With best wishes for a less volatile New Year.

Exhibit : Characteristics of Board Risk Committees for 27 major EMEA Banks[2]

Feature		Number of Banks with feature
Have Board Risk Committee:	Separate Board Risk Committee	17
	Combined Audit & Risk Committee	3
Separate Board Risk Committee established:	2007 and earlier	10
	Since start of 2008	7
Board Risk Committee includes members with Financial Services Risk experience:		5
Board Risk Committee mandate includes the provision of oversight and advice to the Board on:	Systems to measure, control, report risks	14
	Risk appetite, tolerance and/or strategy	13
	Alignment of strategy and risk appetite	6
	Alignment of reward structures and risk mandate	5
	Current and future potential risk exposures	6
	Developing a culture of risk awareness	2

2 Source: Company websites and Annual Reports as at 1st November 2010

OLIVER WYMAN

Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialised expertise in strategy, operations, risk management, organisational transformation, and leadership development.

About the authors

Dr. Christian Pedersen, Partner, Finance and Risk Practice

Michelle Daisley, Senior Manager, Finance and Risk Practice

For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

EMEA	North America	Asia Pacific
+44 20 7333 8333	+1 212 541 8100	+65 6510 9700