1
Introduction

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In the years since the 2007–2009 financial crisis, a number of expectations and requirements for financial institutions have changed and been published. Alongside technical issues, such as changes to capital requirements, stakeholders have outlined their expectations for revitalised oversight of risk issues by the Board.

This book is intended to support Non-Executive Directors (NEDs) in their oversight of risks to which the firm is exposed. While some NEDs will specialise in particular topics, such as risk, the Board has overall responsibility for risk oversight. This oversight of risk is part of the Board's responsibility for supervising the activities of the Executive and establishing boundaries within which they act. To promote an effective dialogue there needs to be shared terminology and concepts, which in turn lead to improved communication and appreciation between the NEDs, the Executive and the risk managers.

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1.1 INTRODUCTION

The topic of risk oversight at the Board level and the materialisation of risk issues have a higher profile since the financial crisis. In response to expectations of NEDs and risk, some firms have established a Board-level Risk Committee, while others may nominate one or more NEDs to be the risk specialist representing the Board on the Enterprise or Group Risk Committee. Risk is an aspect of many, if not all, discussions at Board meetings. For example, risk is expected to feature in the discussions on compensation, business tactics and strategy.

Over the past 30 years the discussion of risk has become increasingly technical. This evolution has been stimulated by initiatives of regulators of the financial sector. Basel I, II and III, European Directives and Dodd–Frank are examples of these initiatives. Very often, these initiatives are transposed into national requirements, each with their own variations that correspond to national priorities or perspectives. For firms that operate in many countries, the complexity generated by national differences can substantially expand the details that affect the Executive and influence Board decisions.

In the post-financial crisis landscape some firms are winners. The winners were either lucky or had something that provided competitive advantage. Unfortunately, luck is not reproducible. A perceived aspect of the competitive advantage through the financial crisis is risk management. There are tales of firms reducing their exposure to particular activities or changing their long/short positions before others and

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weathering the crisis better than others. Whilst some firms got through the financial crisis, the winners were able to grasp opportunities.

This competitive advantage through risk management did not arise by accident; it developed over time and is an integral part of how these firms operate. Not all firms are the same, not all firms face the same risks to the same extent and so a single template is not appropriate. Nevertheless, there will be common themes such as the risk appetite, monitoring compliance with the risk appetite, risk and return, and the variety of risks with different emphases. Pro-active oversight of risk by the Board is now an expectation of many powerful stakeholders to prevent crises and reinforce the competitiveness of the firm. To meet this objective the Board needs to have a meaningful dialogue on risk with the Executive. With the technical evolution of risk, this is not a simple objective.

Some risk management queries are universal, but will only take the risk oversight and challenge dialogue so far:

(a) What can go wrong?
(b) How likely is it to go wrong?
(c) How badly wrong can it go?
(d) What is the relative upside versus downside?
(e) What can be done to manage the downside and change the ratio to the upside?

The Board, and their designated risk specialists, need sufficient knowledge to enable a productive dialogue with the Chief Risk Officer (CRO) or their risk specialists, such as the Chief Credit Risk Officer (CCRO), but without replicating the full extent of their knowledge. Risk is also expected to be an integral part of the Board's dialogue on strategy with heads of businesses and countries or regions. Without going into extensive detailed technicalities, this book supports that productive dialogue.

The rest of this chapter looks at:

1.2 Boards
1.3 Why Now?
1.4 Rest of the Book

1.2 BOARDS

Irrespective of the jurisdiction in which it operates, one of the Board's responsibilities is the oversight of risk.

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In non-legal terms, the Board has a number of responsibilities:

- strategy formulation,
- policy making,
- oversight of Executives, and
- accountability to the owners of the company.

Risk is a subtext to all of these responsibilities.

The expectation is that the NEDs on the Board will be able to provide "constructive challenge to the decisions and effective oversight" of the Executive.[1] The European Banking Authority (EBA) expectation is that NEDs "should be able to demonstrate that they have, or will be able to acquire, the technical knowledge necessary to enable them to understand the business of the credit institution and the risks that it faces sufficiently well".

One approach to meeting this objective is to have a NED who has the role of being more expert than others on risk issues. Nevertheless, the Board has shared responsibility, even in the presence of specialists. The optimal attributes required of a risk specialist NED have been grouped into the following categories:[2]

- risk management acumen
- personal attributes
- business acumen
- education.

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Each of these categories is supported by subcategories such as "an understanding of how incentive and compensation design influence risk taking". Alongside these headings is the necessary experience, for example having been a CRO and experienced a complete business cycle. These attributes, when considered as a set, are challenging. As not all firms are the same, so the importance of meeting certain attributes will vary by firm. Depending upon the exact role, the variety of experience may be more important than its duration, for example 20 years' practical knowledge of a narrow aspect of banking may be of limited value. The suitability of experience needs to be proportional to the firm's activities in terms of scope, scale and complexity.

[1] European Banking Authority (November 2012), paragraph 14.6.

[2] The Directors and Chief Risk Officers Group, "Attributes of a qualified risk director" – these are intended to be broadly applicable.

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1.3 WHY NOW?

Following the 2007–2009 financial crisis there were many initiatives by:

- governments,
- trans-government bodies (such as the G20),
- financial regulators (national and international), and
- industry bodies.

These initiatives are intended to prevent reoccurrence of an equally grave crisis and fall into two broad categories – governance and technical. The initial rush of initiatives appears to be over and the focus is upon migrating from concept to rules and requirements. Firms are implementing various processes in response to these rules and requirements and are being "encouraged" by regulators, regulatory groups (such as the Basel Committee) and politicians with deadlines.

1.3.1 Governance Expectations

Stakeholder expectations on governance have been published, including:

- the Walker Report,[3]
- documents from the Financial Reporting Council[4] and the International Corporate Governance Network,[5] and
- the UK Report of the Parliamentary Commission on Banking Standards.

In some instances the expectations and requirements apply to the entire corporate sector, in others they relate specifically to banks and other financial institutions.

The EBA has produced a set of guidelines to focus on the experience of individuals on the Board and key Executive functions.[6] These guidelines apply to unitary as well as two-tier Boards. These functions can also be known as significant influencing functions (SIFs). Several national regulators had SIF regimes established before the publication of the EBA guidelines. These regulators were able to raise their expectations

[3] HM Treasury (November 2009).

[4] http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx

[5] https://www.icgn.org/

[6] European Banking Authority (November 2012).

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and implement the new standards almost immediately. In some cases, this has been accompanied by greater assertiveness by the regulators about SIFs meeting these expectations. These guidelines were adopted by EU banking regulators in May 2013.

For regulators that already had a SIF regime, the interviews may, originally, only have been conducted pre-appointment. A satisfactory outcome influenced whether the appointment could proceed. With the changed environment, it is expected that these interviews with regulators will occur on a regular basis when the individual has been in position for a period of time.

Some regimes are expected to go beyond the SIF interview prior to appointment and these "in-position" inverviews.[7] The UK regime has a proposal that SIFs, "in a case of failure, should demonstrate that they took all reasonable steps to prevent or mitigate the effects of a specified failing".[8] This obligation is reinforced by the suggestion that a criminal offence should be created for SIFs "carrying out their professional responsibilities in a reckless manner". It is not clear if other jurisdictions will adopt similar expectations and sanctions.

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1.3.2 Technical Changes

In addition to changes in expectations on governance, the post-financial crisis technical changes are adding complications and complexity for the firms. Some of these technical changes are expected to amend the business models as they have implications for return on capital. Other changes will affect the organisational structure of firms. These changes have consequences for Board-level oversight of risk and effective challenge of the Executive.

Amongst the complicating factors is the characterisation of some financial firms as systemically important financial institutions (SIFIs) by the Financial Stability Board (FSB).[9] The designation of SIFI means that the firm is important to the smooth operation of domestic and global financial systems.[10] The implication of being a SIFI means that the firm

[7] UK Report of the Parliamentary Commission on Banking Standards, p. 10.

[8] The Parliamentary Commission on Banking Standards refers to "Senior Persons".

[9] Financial Stability Board (2011, 2012).

[10] The FSB plans to review the list of SIFIs on an annual basis, possibly moving firms between categories of SIFIs, adding or deleting firms from the list. The FSB is also considering whether some insurance companies, and other parts of the financial sector, should be given a SIFI designation.

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needs a sophisticated approach to risk management and its oversight, as well as holding additional capital.

In some regimes the technical changes are likely to result in different business models for banks. The changes that fall into this category include:

- the Volker proposals, in the Dodd–Frank Act in the USA,
- the Vickers Report in the UK,
- "Living Wills" – resolution and recovery plans, and
- liquidity risk requirements.

These initiatives will affect proprietary trading, the separation of retail from wholesale banking, the distribution of capital within a group, guarantees provided to subsidiaries and sources of funding, as well as internal transfer pricing for funding. While the scope of some initiatives will be national, their consequences may be international. For example, a reduction in proprietary trading may affect the liquidity of individual securities with consequences for their use as collateral to mitigate credit risk.

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These technical changes add complexity to the Board's oversight of existing risks. In addition, responding to these regulatory initiatives is expected to alter the risk profile of the firm. While some risks may diminish – the underlying purpose of these technical changes – other risks can be expected to raise their profile, and potentially new risks may be added.

1.4 REST OF THE BOOK

The rest of the book is in three parts (see Figure 1.1): Risk Oversight, Specific Risks and Regulatory Environment.

Part I describes the main elements of the risk management and oversight apparatus. A challenge is to arrive at a conceptual description of the various elements and practical implications.

Most of the chapters in this part contain sections on terminology. This terminology, when combined with the description of the risk oversight apparatus, will support a dialogue, including challenge, as opposed to engaging in a monologue with the potential to be confused and frustrated. The organisational and human aspects, for example risk culture and biases, which can affect decision making are also covered in this section.

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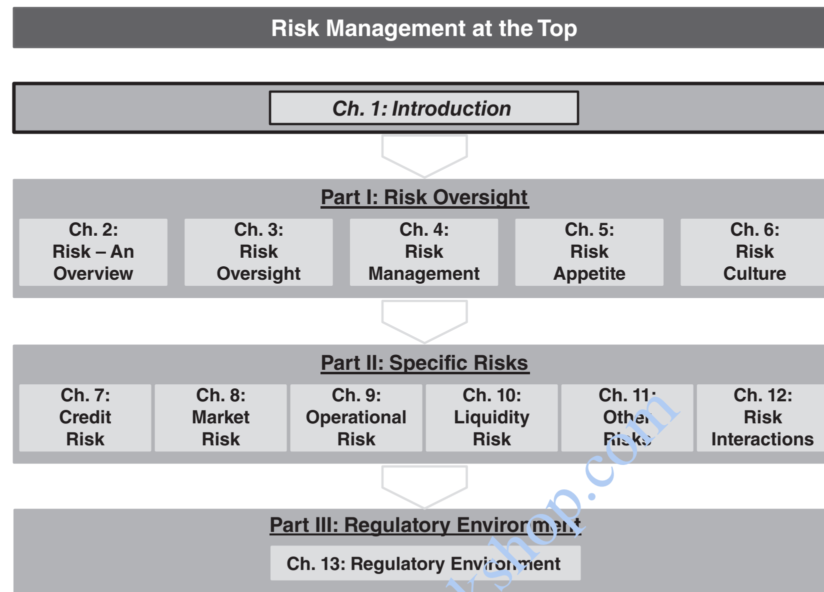

Figure 1.1 Book overview

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Risk management, appetite and culture are all part of the risk consciousness of the organisation. For a portion of these topics the Board needs to perform a comparison between where the firm is and where the Board wants it to be, communicating any changes to the Executive for implementation.

Part II covers risk types that are common to financial firms. Other risk types, such as underwriting risk or investment risk, may be specific to subsections of finance such as insurance. Some second-order effects are described, where one risk source can influence the severity of another risk source. This interaction presents a challenge for risk oversight and management.

Part III looks at the regulatory environment. The regulatory framework is influential on the firm's risk management through the creation of technical requirements and governance expectations, for example "principles for enhancing corporate governance". The technical requirements have consequences for the amount and composition of capital of the firm. In turn, this has consequences for various stakeholders, for example the impact on dividends.

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FURTHER READING

Basel Committee on Banking Supervision (October 2010) Principles for Enhancing Corporate Governance. http://www.bis.org/publ/bcbs176.pdf

European Banking Authority (November 2012) Guidelines on the Assessment of the Suitability of Members of the Management Body and Key Function Holders. http://eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2012/EBA-GL-2012-06–Guidelines-on-the-assessment-of-the-suitability-of-persons-.pdf

Financial Stability Board (4 November 2011) Policy Measures to Address Systemically Important Financial Institutions. http://www.financialstabilityboard.org/publications/r_111104bb.pdf

Financial Stability Board (1 November 2012) Update of Global Systemically Important Banks. http://www.financialstabilityboard.org/publications/r_121031ac.pdf

HM Treasury (November 2009) A Review of Corporate Governance in UK Banks and Other Financial Industry Entities – Final Recommendations [the Walker Report]. http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf

The Directors and Chief Risk Officers Group (5 June 2013) Qualified Risk Director Guidelines. http://www.thegovernancefund.com/DCRO/PDF/Qualified_Risk_Director_Guidelines.pdf

UK Report of the Parliamentary Commission on Banking Standards (June 2013) Changing Banking for Good. http://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf

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