In Search of Risk Experts for Bank Boards

••Regulatory requirements and risk awareness have created a demand for risk expertise.

BY JAMES LAM AND STEVE POTTER

IN THE AFTERMATH of the 2008 global financial crisis, bank boards are taking a much more active role in overseeing enterprise risk management (ERM) at their institutions. Bank directors face greater liability from shareholders and regulators,[1] more stringent regulatory and disclosure requirements, and higher expectations from key stakeholders. At the same time, banks face significant risks, including geopolitical turmoil, economic and business uncertainty, and business model challenges posed by greater regulatory constraints and costs.

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Bank directors recognize the significant uncertainties they face, and recent surveys indicate that risk management has emerged as one of their top concerns. So what can bank directors do to improve risk oversight? The key levers include establishing an effective governance structure to oversee ERM, approving a risk policy that includes a risk appetite statement, and establishing reporting processes to monitor risk management effectiveness.[2]

To fulfill their fiduciary responsibility for risk oversight, however, bank boards must obtain the requisite human capital and talent. And indeed, industry observers have reported a sustained high demand for risk professionals from corporate boards and executive suites, regulatory agencies, consulting firms, and other organizations. This demand is seen across traditional and emerging sectors[3] as well as global markets.[4]

Given the growing demand for top-notch risk talent, boards should address the following key questions:

1. Which key regulatory requirements must bank directors consider as part of their risk governance and oversight?
2. What are the current industry practices in board risk governance, and which professional credentials are found at bank boards today?
3. What should the criteria and job description be for a "risk expert" at the board level?
4. To improve their risk governance, which actions should all bank boards consider taking today?

Regulatory Requirements

The level of regulatory scrutiny on risk management at financial institutions has never been greater. Moreover, directors and officers of failed institutions face substantial exposure to professional liability lawsuits from regulators and shareholders. Consider the following regulatory mandates faced by bank boards:

- *Dodd-Frank Act.* Section 165 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act established new requirements for risk management oversight by bank boards. This provision mandates that each publicly traded bank holding company with total consolidated assets of over $10 billion establish a risk committee of the board that includes at least one risk management expert. The risk committee of the board is responsible for "the oversight of the enterprise-wide risk management practices." The Federal Reserve Board may also require a risk committee at smaller publicly traded bank holding companies. There are parallels between Section 165 of the Dodd-Frank Act and Section 407 of the 2002 Sarbanes-Oxley Act (also known as the Public Company Accounting Reform and Investor Protection Act), which called for the creation of audit committees staffed by independent directors and at least one "financial expert." However, unlike Sarbanes-Oxley rules that define the attributes of a financial expert,[5] Dodd-Frank does not provide specific criteria on what would qualify a board member to be a "risk expert."
- *SEC Disclosure Requirements.* In December 2009, the Securities and Exchange Commission released a new set of rules designed to enhance transparency around the role of the board in risk oversight. These rules require publicly traded companies to disclose board risk governance and oversight processes in proxy and information statements. These disclosure requirements apply to board risk governance structure, the relationship between compensation policy and risk management, and the extent to which executive compensation may lead to excessive risk taking. These requirements also highlight the necessary qualifications of directors and nominees, as well as the extent to which diversity plays a role in director nominations.
- *Basel III.* In December 2010, in response to the deficiencies in financial regulation during the 2008 financial crisis, global banking regulators established Basel III to improve capital adequacy, stress testing, and risk management practices with respect to counterparty, liquidity, and systemic risks. Basel III requirements will significantly increase the capital and liquidity costs for banks with over $50 billion in assets. Basel III will also impact the capital management practices and dividend policies throughout the banking industry.

The combined impact of Dodd-Frank, the SEC, Basel III, and other regulatory requirements has far-reaching implications for the overall profitability of banking institutions.

Previous spread: Photodisc/Thinkstock

Wanted: Risk Expert to Serve on Bank Board

COMPANY DESCRIPTION

This Fortune 500 multinational bank holding company has operations in 20 countries and customers worldwide. In compliance with recent Dodd-Frank legislation, the company seeks to add a board member who is a risk expert and whose main responsibility will be to chair the newly mandated Risk Management Oversight Committee.

TITLE AND JOB DESCRIPTION

Position: Member of the board of directors and chairman of the Risk Management Oversight Committee.

The company seeks a director to chair the Risk Management Oversight Committee. The director must have industry-specific, executive-level experience and be capable of assisting the board and CEO in assessing the bank's risk profile and overseeing the bank's risk management activities. The successful candidate will have had experience that includes significant management responsibilities for a diverse set of enterprise risks. The director will ideally hold or have held a position as a CRO or equivalent and will have a thorough understanding of board governance and risk oversight practices.

RISK MANAGEMENT OVERSIGHT COMMITTEE

The majority of the committee will be composed of independent directors, including one risk expert. The purpose of the committee is to assist the board and the CEO in providing oversight of the firm's key risk exposures and risk management strategies. The committee reports to the board with respect to the company's overall risk profile and makes recommendations with respect to risk policies and strategies. In order to establish independence of the risk function, the CRO has dual reporting relationships with the CEO and the chairman of the Risk Management Oversight Committee.

DUTIES AND RESPONSIBILITIES

Charter

The committee will have direct access to all management personnel and information related to its risk oversight responsibilities. In addition to regularly issued reports, management is obligated to provide custom reports upon the committee's request. The chair and the committee have the authority to conduct or authorize full investigations into any and all areas within its jurisdiction.

Meetings

The committee will meet at least once a quarter and more frequently if necessary. It shall report to the board at each regularly scheduled board meeting.

Oversight

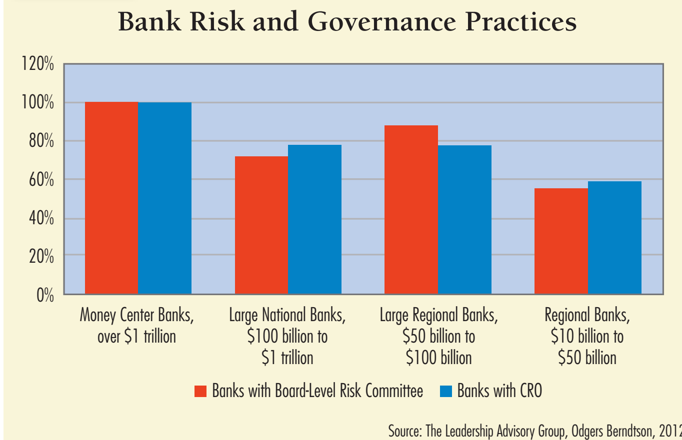
The chairman and the committee will review all risk matters within its charter annually or more frequently if deemed advisable or necessary. This oversight will include the following:

- Review key risk reports and policies; recommend changes in board risk reporting, key risk limits and tolerances, and risk-mitigation plans.
- Monitor the bank's key risk exposures and management's treatment of all forms of strategic and business risks, financial risks (credit risk, market risk, liquidity risk, derivative exposures, etc.), and operational risks (cyber risk, terrorism risk, event risk, regulatory risk, social media risk, etc.).
- Work closely with the Audit Committee, with the assistance of internal audit, to provide annual assurance that the ERM program is working effectively; this would include reviewing risk management performance metrics and model validation results.
- Assess and evaluate the capabilities and performance of the firm's senior risk management and compliance teams, including the CRO.
- At least once a year, review the bank's risk management policies, risk limits and tolerances, stress-test results, and economic capital analyses to ensure that the bank's overall risk profile is consistent with its risk management and absorption capabilities.
- Assist the full board in integrating the oversight of strategy and risk, including overseeing management's development of early warning indicators and contingent capital/liquidity plans to ensure that the bank is prepared for extreme business scenarios and contingencies.
- The chair and the committee will receive copies of all regulatory and audit reports that cover matters within the committee's review.

COMPENSATION

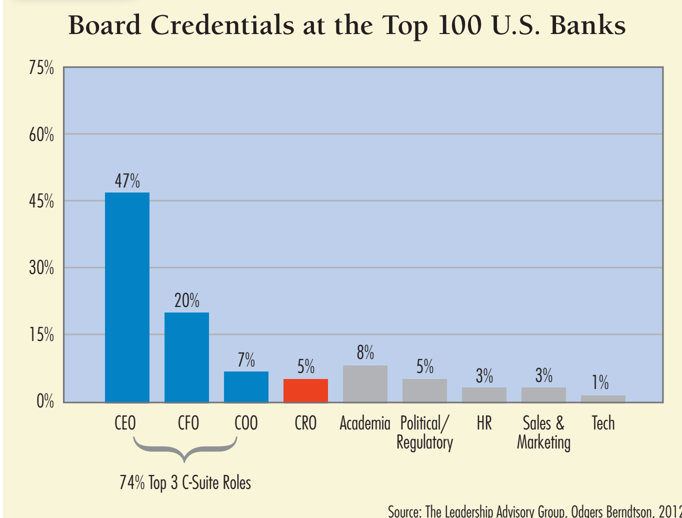
As a regular member of the board, the chairman of the Risk Oversight Committee will receive the annual board fee of $60,000 per annum. As committee chairman, the successful candidate will receive a supplementary $20,000 and an additional $1,000 per committee meeting. All properly documented expenses will be covered or reimbursed by the company. All directors will participate in the director stock option plan, which is intended to align the directors with shareholders' interests and may equal or exceed the value of their cash fee. ❖

Figure 1



Source: The Leadership Advisory Group, Odgers Berndtson, 2012

Figure 2



Source: The Leadership Advisory Group, Odgers Berndtson, 2012

A key impact is that these regulatory requirements have created significant demand for bank directors who can assist the board in overseeing complex risks and regulatory requirements, as well as help executive management in formulating the appropriate business strategies and plans.

Current Bank Board Practices

What are the current industry practices in board risk governance, and what mix of professional credentials is found at bank boards today? To answer this question, the Leadership Advisory Group of Odgers Berndtson conducted research on the top 100 U.S. banking institutions. (Coincidentally, there are almost exactly 100 banks with over $10 billion in assets, which is the Dodd-Frank threshold for requiring a board risk committee.)

As shown in Figure 1, the money center banks with over $1 trillion in assets all have risk committees of the board. They also all have a chief risk officer (CRO) who supports the board risk committee with respect to risk assessment and reporting. For large national banks with between $100 billion and $1 trillion in assets, 71% had a board risk committee and 78% had a CRO. For large regional banks with between $50 and $100 billion in assets, 88% had a board risk committee and 76% had a CRO. For regional banks having between $10 and $50 billion in assets, only 55% had a board risk committee and 58% had a CRO.

Based on the regulatory requirements discussed above, it is expected that 100% of these banks will establish a board risk committee in the next one to two years. It is also likely that nearly all of these banks will have a CRO given the high correlation between having a board risk committee and a chief risk officer.

What are the credentials found at bank boards today? The Leadership Advisory Group of Odgers Berndtson reviewed the professional biographies of over 1,200 directors at the top 100 U.S. banks. Our research and analyses produced the following observations:

- On average, there are 12.7 directors on each bank board.
- Currently 44% of bank boards have at least one director who may be considered a "risk expert." That means 56% of the top 100 U.S. bank boards must add one or more risk professionals to their ranks to satisfy Section 165 of the Dodd-Frank Act.
- As shown in Figure 2, the research found the following distribution of board member credentials:
  - A significant portion of bank board members come from CEO (47%), CFO (20%), and COO (7%) backgrounds.
  - Only 5% come from CRO or risk backgrounds.
  - Other backgrounds include academia (8%), political or regulatory entities (5%), human resources (3%), sales and marketing (3%), and technology (1%).

Given the above findings, and in order to meet regulatory requirements, the number of risk professionals on the top 100 U.S. bank boards should more than double over the next few years.

Criteria for a "Risk Expert"

As bank boards add risk professionals to their ranks, which skills and experiences should they look for?

The Dodd-Frank requirement specified that the risk committee must have "at least one risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms." However, beyond meeting regulatory requirements, banks should recruit directors who can add strategic value to the institution. As such, bank boards should consider the following criteria in their selection process:

- An understanding of risk governance and management practices at banks, including board risk oversight, risk

policy and appetite, monitoring and assurance processes, and risk reporting and disclosure requirements.

- Experience as a chief risk officer, and/or actively supervising a chief risk officer, at a large, complex financial institution.
- Knowledge of banking regulations and standards, such as Dodd-Frank, Basel II and III, SEC, FDIC, OCC, and Federal Reserve requirements.
- Working experience in identifying, assessing, and managing the key risks faced by financial institutions, including strategic, business, market, liquidity, credit/counterparty, operational, and systemic risks—plus experience in integrating strategy and risk oversight.
- Knowledge of ERM, including assessment of cross-risk interdependencies and aggregate risk profiles, and the ability to oversee the CRO's implementation of the ERM program.
- Ability to lead or advise the board on major risk governance and policy issues, as well as guide or challenge management on recommended risk strategies, plans, and assumptions.
- Experience in overseeing or executing applications of key risk management tools, including value-at-risk, economic capital, risk-adjusted pricing and profitability models, risk-control assessments, stress testing, and scenario analysis.
- Understanding of both the usefulness and limitations of the above tools, in addition to a solid understanding of derivatives and hedging strategies.

A sample position description and a typical compensation package are provided in the box on p. 19.

Key Actions

Now facing greater regulatory and business requirements, bank boards should consider taking the following actions to improve risk governance and oversight:

- Review the bank's current risk profile, as well as the projected risk profile given the strategic plan. The current and projected risk profiles will inform the board with respect to its risk oversight requirements.
- Assess the skills and competencies of current board members and then determine if the board should recruit new members with risk management expertise. In addition, develop a risk-focused board training program.
- Review the board's risk governance structure and establish a risk committee if one does not exist. Rationalize the risk oversight responsibilities for the full board, risk committee, audit committee, and other subcommittees. Review and update the charters as appropriate.
- Examine the reporting relationship between the board and the CRO, and ensure that the office of the CRO is sufficiently independent.
- Review the risk policies, risk appetite statement, risk-tolerance levels, board reporting processes, ERM development plans, and assurance processes to determine if they meet the requirements and expectations of the board.

The bar has been raised significantly with respect to board risk oversight at banking institutions. A key driver of these standards is the influx of new regulatory requirements discussed above. In addition, bank boards face higher expectations from institutional investors, rating agencies, and other key stakeholders.

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Ultimately, U.S. banks must enhance their business and risk management practices in order to meet stakeholder requirements and remain competitive in the current environment. In the post-crisis era, bank directors recognize that they must invest more time and effort in overseeing risk management. In this regard, they should determine if adding risk experts to their ranks is an appropriate initiative. ❖

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Notes

1. Between July 2010 and January 2012, the FDIC filed 21 professional liability lawsuits against 178 directors and officers. These lawsuits were related to 20 failed institutions. Total damage claims came to nearly $2 billion. In comparison, the FDIC didn't file any professional liability lawsuits between 2007 and 2009. See "Characteristics of FDIC Lawsuits against Directors & Officers of Failed Financial Institutions," www.bankdirector.com, February 1, 2012.

2. See "The Role of the Board in Enterprise Risk Management," *The RMA Journal,* April 2011.

3. For example, a consultant retained by the Obama administration to review the risks of the U.S. Energy Department's energy loan programs recommended the creation of a CRO at the department. See "Energy Loans a Safer Bet Than Congress Anticipated, Review Shows," www.bloomberg.com, February 11, 2012.

4. For example, executive recruiters reported high demand for risk professionals at banks in the United Arab Emirates, mentioning also a 28% increase in risk vacancies in 2011 and a projected 400% increase in global demand. See "Risk Professionals in High Demand in UAE Banks," www.emirates247.com, December 31, 2011.

5. See "SEC Adopts Rules on Provisions of Sarbanes-Oxley Act," SEC 2003-6, January 15, 2003.