Comment

Risk governance at large banks: Have any lessons been learned?

Received (in revised form): 24th November, 2009

Alessandra Mongiardino*

is VP – Senior Credit Officer and team leader for Moody's Risk Management Group. In her role she provides specialist expertise to Moody's rating teams and has a regular dialogue on risk management practices with some of the largest financial firms worldwide, as well as with regulators and international bodies. Alessandra started her career as a specialist economist at the Bank of England. She holds a PhD in Economics from the University of Warwick and is a member of the Risk Who's Who.

Christian Plath

is VP Senior Analyst and team leader for Moody's Corporate Governance Group. Chris is responsible for publishing corporate governance commentary on individual issuers, publishing topical research, conducting training for Moody's analysts on corporate governance issues, and participating in rating committees across Moody's various sector teams. Before joining Moody's in 2005, he was associate director of the Global Corporate Governance Research Center at The Conference Board, an independent business membership and research organisation.

*Moody's Investors Service Ltd, 1 Canada Square, Canary Wharf, London E14 5FA, UK
Tel: +44 (0) 20 7772 1608; E-mail: alessandra.mongiardino@moodys.com

Abstract The role of the board of directors (or supervisory board) in overseeing risk at financial firms has come under scrutiny during the recent financial crisis. Similarly, questions have been asked about the authority of banks' chief risk officers and the independence of the risk management function. Despite market and regulatory pressures, however, risk governance at large banks seems to have improved only to a limited extent since the beginning of the recent financial crisis and there is still significant room for improvement.

Keywords: *risk governance, risk management, corporate governance, financial crisis*

INTRODUCTION

The current financial crisis has highlighted the importance of robust board-level risk oversight in helping to ensure the safety and soundness of large financial institutions. The failure of the directorial boards of such institutions to oversee risks properly is widely viewed as contributing to the crisis. Over the past two years, calls for an enhanced board role in risk oversight have been made not only at the national level, but also by supra-national regulatory authorities, including the Basel Committee on Banking Supervision.[1] Industry groups, such as the Institute of International Finance[2] and the Group of 30,[3] have also called for improvements in this area.

Effective board-level risk oversight and, more broadly, robust risk management depend on a number of factors relating to the firm's people, processes and organisation and, in the end, the firm's own 'cultural DNA'.

Key characteristics of robust risk oversight at financial institutions include the board of directors' explicit articulation and approval of the firm's risk tolerance, and their full awareness and understanding of the firm's risk profile. A strong risk culture, championed by the board, is also a crucial element of an effective risk management framework.

To perform its role in an effective fashion, a firm's board needs to have a sound committee structure, with meetings sufficiently frequent to ensure a thorough and timely review of the firm's risk profile and discussion of any remedial action that might be required. Moreover, the most effective board committees will often include, among their members, individuals with extensive and proven experience in banking and risk management. The independence of the committee members and the presence of an authoritative chief risk officer (CRO) are also key elements of robust risk governance.

This paper highlights best practices in the organisational aspects of risk governance, and reviews the progress in risk governance at large banks since the beginning of the financial crisis. It argues that a sound board committee structure and appropriate organisational structure for the risk function and CRO do not in themselves guarantee strong risk management. Nevertheless, they can provide a sound base on which to build effective risk management.

SCOPE OF ANALYSIS AND BEST PRACTICES

While there has been extensive discussion in the banking industry on the importance of establishing high-quality risk governance practices, there has been less debate on the progress made since the beginning of the financial crisis.

This paper presents an assessment of risk governance practices for 20 large banks (defined as having assets in excess of US$300bn as of end 2008). The paper compares the status of the banks at the time of writing (end of October 2009) versus the start of the crisis, in July 2007. The analysis is based on data from the banks' websites and from proxy statements and annual reports for the years ending 2007 and 2008. The institutions examined include both highly complex institutions and large commercial and universal banks from Europe and North America. The paper also considers the potential impact on the pace of progress due to government part-ownership.

Specifically, the analysis focuses on the following features:

- board-level committees in charge of risk issues and the frequency of their meetings;
- risk committee composition for those banks with a dedicated all-risk committee;
- the existence of a designated CRO, and their reporting line and status in the management structure of the firm.

Most large banks run complex businesses, with many different business lines, often including non-banking activities. Understanding all the risks to which these institutions are exposed, how they interrelate and how they could expose banks to losses well beyond their risk tolerance takes both skill and time. Without this awareness, however, it is difficult for the board to provide effective checks and balances to the bank's management. For these reasons, large banks, such as those examined in this paper, should meet the following best practices:

- There should be a dedicated board-level risk committee to supervise all types of risk. This should meet on a frequent basis (at least bi-monthly). While the full board retains ultimate responsibility for risk oversight, it is unrealistic to expect it to discharge its duties effectively without a robust committee structure. Moreover, given the significant burden placed on audit committees in recent years, it is very challenging for them to ensure focused oversight of both financial reporting/controls and risk management.
- The majority of the risk committee members should be independent, with extensive first-hand banking experience. At least some independent members should have previous risk management experience.
- The CRO should be a member of the bank's executive committee and report jointly to the CEO and the board.

PROGRESS SINCE THE START OF THE CRISIS

All-risk board committees are not yet common

In terms of using committees to gain a more focused understanding of risk, bank boards have historically adopted various approaches, typically assigning responsibility to the audit committee or to a committee focused on either all risks or specific risks only (eg credit risk). This paper therefore distinguishes those banks with an all-risk board committee from those with a board committee that oversees only specific risks, and those with no dedicated risk committee, in which the audit committee assumes responsibility for risk oversight in addition to its other duties.

Table 1: Board committees overseeing risk

	July 2007	October 2009
Banks with all-risks committee	BAR, BNPP, CS, DB, LLOYDS, SAN, CIBC, JPM (8)	BAR, BNPP, CS, DANSKE, DB, LLOYDS*, RBS*, SAN, UBS, BAC*, CIBC, JPM (12)
Banks with committee for specific risks only	DANSKE, BAC (2)	n/a
Audit committee only	HSBC, KBC, RBS, SG, UNICREDIT, CITI, GS, MS, WELLS (9)	HSBC, KBC*, SG, UNICREDIT, CITI*, GS, MS, WELLS (8)
Other	UBS (1)	n/a

* Indicates government part-ownership or extraordinary government assistance

As shown in Table 1, the number of large banks that have, or are in the process of forming, a board-level all-risk committee has increased since the beginning of the crisis; nonetheless, the practice is not yet widespread. Specifically, only 12 of the 20 banks considered in this study had a board-level all-risk committee by the end of October 2009. In the remaining banks, the audit committee retains responsibility for risk oversight.

Out of the four banks that have established, or are in the process of establishing, a dedicated board committee for all risks, two (Bank of America and RBS) are currently part government-owned or have received extraordinary government assistance. At the same time, not all part government-owned banks have enhanced their board committee structure; in particular, Citigroup and KBC do not have yet a board-level all-risk committee.

Risk committees meet relatively infrequently

While frequent meetings are by no means sufficient for robust risk governance, infrequent meetings suggest that the board has insufficient time to review and discuss risk issues or to respond in a timely fashion to any change in the bank's risk profile. At times of heightened market volatility it is not unreasonable to expect all-risk committee meetings to be held on a bi-monthly basis. In this light, the study considers the frequency of all-risk committees in 2008 (the frequency of all-risk committee meetings for 2009 cannot be determined until annual reports and proxy statements for 2009 are published).

The results show that, of the nine banks with an all-risk committee, only five had at least six meetings in 2008 (see Table 2). It is of course possible that the risk committees had both informal and formal meetings. All the same, this result, coupled with the fact that only 12 of the 20 banks in the sample have a dedicated all-risk board committee, suggest significant room for improvement, particularly in light of the recent financial crisis.

Table 2: Frequency of all-risk board committees in 2008

Meeting frequency	Institution
Up to four meetings	BAR, CS (2)
Five or six meetings	BNPP, LLOYDS, CIBC (3)
More than six meetings	DB, SAN, JPM (3)

Among the banks that had more than six all-risk board committee meetings, one (Santander) held 102 meetings during 2008. This is a significant outlier compared with the other banks in the sample, which recorded a maximum of eight meetings. Moreover, this group's board has a significant representation of non-independent members on the committee. The two combined features (meeting frequency and committee composition) might suggest a potential blurring of the lines between oversight and management for this bank.

Room for improvement in risk committee composition

Having a dedicated board committee that covers all risks and that meets frequently is an important element of robust risk governance for a bank, but by itself it is not sufficient. The experience and independence of the committee members is another important element, given that board members with the appropriate expertise may be in a better position to challenge and provide the appropriate checks and balances to management.

Having assessed the banks with established all-risk committees as of the end of October 2009, this study finds that:

- at two banks, the members of the risk committee are mainly former executives of the same institutions and therefore not strictly independent;
- three banks have no independent committee member with previous risk management and/or banking experience;
- two banks have only one independent committee member with risk management/banking experience;
- one bank has independent committee members with previous experience in

financial services but not in risk management.

For those banks that had an all-risk committee prior to the financial crisis, changes in the membership of the committee, either in the expertise of the board members, or in the level of independence, do not appear to be material. Meanwhile, for those banks that established an all-risk committee over the last two years, only in one case did the committee appear to have a comprehensive representation of banking and risk management expertise. As previously noted, the comprehensive representation of relevant skills in the all-risk committee cannot, by itself, guarantee the effectiveness of the board in discharging its risk oversight duties. Nevertheless, it is clearly important in terms of supporting strong checks and balances.

Most banks have a CRO, but position and reporting lines need strengthening

As discussed above, both industry and regulators have recently emphasised the importance of not only the role of the board of directors in risk oversight, but also the authority of the CRO. The insufficient authority of some CROs, and the lack of regular contact between them and their banks' senior executives and board members, have been deemed important factors contributing to the management failures at some banks (eg see the BIS *79th Annual Report*[4] and the Senior Supervisors' Group report on *Risk Management Lessons from the Global Banking Crisis of 2008*[5]). Going forward, a strong and empowered risk management function is a key element for more resilient banks. It is not easy to assess a CRO's effectiveness and authority; however, one can get an idea of their positioning within their firm by examining both the reporting line and their position with respect to the bank's management team (see Table 3).

Given the size and complexity of the banks examined in this paper, it is perhaps not surprising that most of the banks had a dedicated CRO as of October 2009 (17 of 20). If anything, the surprise lies in the fact that not all of the banks had a dedicated CRO — the exceptions being Danske Bank, RBS and Wells Fargo. In 16 of the 17 banks with a CRO, this person was a member of the bank's executive management team.

With reference to the reporting line in the banks with a CRO, the CRO reports directly to the CEO (or the CEO and the board) in 14 of the 17 banks. For the remaining three banks (Barclays, HSBC and Goldman Sachs), the CRO reports to the firm's chief financial officer (CFO). In only two of the banks in the study (JPMorgan Chase and Santander) does the CRO report to both the CEO and the board, which is the industry best practice.

As with the earlier discussion about committee structure and risk oversight, recent developments in risk governance have been limited. During the study period, there was little change in the positioning of CROs, or indeed in their quantity — the number of banks with a dedicated CRO increased from 16 to 17. Furthermore, not all changes indicate progress in risk governance. For example, at the time of writing, RBS does not have a dedicated CRO. Instead, since June 2009, it has had a Head of Restructuring and Risk. The person in this role has a place on the executive committee and reports to the group CRO. The executive in this position is

Table 3: CRO position and reporting line

	July 2007	October 2009
Dedicated CRO	BAR, BNPP, CS, DB, LLOYDS, RBS, SAN, SG, UBS, UNICREDIT, BOA, CIBC, CITI, GS, JPM, MS (16)	BAR, BNPP, CS, DB, HSBC, KBC*, LLOYDS*, SAN, SG, UBS, UNICREDIT, BOA*, CIBC, CITI*, GS, JPM, MS (17)
— CRO member of the executive committee	BNPP, CS, DB, LLOYDS, SAN, SG, UBS, BOA, CIBC, CITI, JPM, MS (12)	BAR, BNPP, CS, DB, HSBC, KBC*, LLOYDS*, SAN, SG, UBS, BOA*, CIBC, CITI*, JPM, MS (15)
— CRO reports to CEO and board	SAN, JPM (2)	SAN, JPM (2)
— CRO reports to CEO	BNPP, CS, DB, LLOYDS, UBS, UNICREDIT, BOA, CIBC, CITI, MS (10)	BNPP, CS, DB, LLOYDS*, UBS, UNICREDIT, BOA*, CIBC, CITI*, JPM, MS (11)
— CRO reports to CFO	BAR, RBS, GS (3)	BAR, HSBC, GS (3)
— Other reporting line	SG (1)	SG (1)
No dedicated CRO	DANSKE, HSBC, KBC, WELLS (4)	DANSKE, RBS*, WELLS (3)

* Indicates government part-ownership or extraordinary government assistance

therefore responsible for business activities and management of the group's non-core business, as well as non-business related functions, namely risk management and legal. This arrangement does not appear to be in line with the best practices discussed previously.

Many of the banks included in the sample have undergone significant staffing changes at senior levels of the risk management function. For example, of the 16 banks that had a CRO in July 2007, eight have since appointed a new individual for that position. While it is too early to assess the long-lasting impact of these changes, it is worth noting that none of the banks with a CRO in place at the start of the study period have strengthened the reporting line, particularly as regards reporting to the board of directors. This does not bode well for the future.

CONCLUSION

The results presented in this paper show that there is significant room for improvement in each of the risk governance areas reviewed. Moreover, even where there has been some improvement since the beginning of the financial crisis, this has been limited, despite the increased emphasis that both regulators and the industry have been putting on strong risk governance and continued government part-ownership of some of these institutions.

Specifically:

- A few institutions included in this sample have set up, or are in the process of setting up, dedicated risk committees, sometimes with the encouragement of the regulatory authorities. However, dedicated risk committees are still not common among large banks, and audit committees are commonly taking responsibility for risk oversight. This risks excessively burdening audit committees, compromising their ability to meet their whole remit, including risk oversight.

- Of those banks with an all-risk committee, only a few hold committee meetings on at least a bi-monthly basis, even in a year of market turmoil like 2008. In these circumstances, it is very challenging for board committees to provide effective and timely risk oversight.
- A review of the membership of all-risk committees indicates that in most cases there is room for improvement either in terms of the actual independence of the committee members and/or the appropriateness of their professional experience and background. In this regard, no material progress was achieved over the last two years.
- Some banks in the study still do not have a designated CRO. Moreover, for those banks that do have a CRO, there has been no significant enhancement in their reporting line over the last two years. To date, only a few banks have a joint reporting line to the executive and the board of directors. This is not in line with best practices and expectations, as a strong relationship between the board and the CRO is key to ensuring effective risk oversight and is too important to be left to informal arrangements.

Some of the changes to banks' corporate governance practices, including their risk governance, are still underway and more may be in the pipeline, particularly following independent reviews such as the Walker Review in the UK and new regulations that may be promulgated as a result. There may also be additional changes to risk governance practices in banks where governments have taken ownership stakes. However, the rate and extent of progress so far do not bode well for the future, especially given that the momentum for reform is dropping as the financial crisis eases. Finally, and most importantly, improvement in the organisational aspects of risk governance, in terms of both the committee structure of the board, and the positioning and the reporting lines for the CRO, is a key step, *but only one step*, towards more robust risk governance.

DISCLAIMER

The views expressed in this paper are those of the authors and do not reflect the views of Moody's Investors Service.

APPENDIX: LISTING OF BANKS REVIEWED IN THIS REPORT

The analysis presented in this paper includes 20 banks based in Europe and North America. All banks had assets of at least US$300bn as of year-end 2008. The below list details the banks examined for this paper, broken down by region and type of institution:

- Europe
  - *Complex institutions:* Barclays (BAR), BNP Paribas (BNPP), Credit Suisse (CS), Deutsche Bank (DB), HSBC, RBS, Société Générale (SG), UBS (8)
  - *Universal/commercial banks:* Danske Bank (DANSKE), KBC, Santander (SAN), Unicredit (UNICREDIT) (4)
- North America
  - *Complex institutions:* Bank of America (BAC), Citigroup (CITI), Goldman Sachs (GS), JPMorgan Chase (JPM), Morgan Stanley (MS) (5)
  - *Universal/commercial banks:* Wells Fargo (WELLS) (1)

References

1 Basel Committee on Banking Supervision (2009) 'Enhancements to the Basel II Framework', July, available at: http://www.bis.org/publ/bcbs157.pdf?noframes=1 (accessed 29th January, 2010).
2 Institute of International Finance (2008) 'Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations', July, available at: http://www.iif.com/regulatory/ (accessed 29th January, 2010).
3 Group of Thirty (2009) 'Financial Reform: A Framework for Financial Stability', January, available at: http://www.group30.org/pubs/recommendations.pdf (accessed 29th January, 2010).
4 Bank for International Settlements (2009) '79th Annual Report', June, available at: http://www.bis.org/publ/arpdf/ar2009e.pdf?noframes=1 (accessed 29th January, 2010).
5 Senior Supervisors' Group (2009) 'Risk Management Lessons from the Global Banking Crisis of 2008', October, http://www.newyorkfed.org/newsevents/news/banking/2009/SSG_report.pdf (accessed 29th January, 2010).