

# What Keeps Board Directors Awake at Night?

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## ***What Keeps Bank Board Directors Awake at Night?***

What keeps you awake at night? Chief Risk Officers are constantly asked this question. As the apparent “bearers of all crosses”, perhaps they should answer “**everything**”. It is not just CROs, or their executive management teams, that should have trouble sleeping. With an ever-increasing focus on governance, boards of directors must focus on risks, traditional and emerging, that could impact the health and stability of their organizations.

- *Would Wells Fargo have been embroiled in a sales practices scandal if the board had paid more attention to conduct risk and its culture?*
- *Would the Commonwealth Bank of Australia (CBA) have avoided its woes if their board paid more attention to anti-money laundering risk and audit reports that raised red flags?*
- *Would Danske Bank have avoided the problems created by its Estonia branch if the board had paid more attention to how its control functions operated?*

That stated, are boards now expected to manage their banks? The clear answer is **NO**. As the Australian Royal Commission states: “Boards cannot, and must not, involve themselves in the day to day management of the corporation.... The task of the board is overall superintendence of the company... an integral part of that task is being able and willing to challenge management on key issues and doing that whenever necessary.”

## **BOARD OF DIRECTORS ROLE**

Canada’s Office of the Superintendent of Financial Institutions outlines the board of directors role as:

Approving and overseeing their institutions’:

- *strategy, strategic initiatives, short and long-term business plans,*
- *risk appetite framework, internal control framework, codes of ethics and conduct, and significant policies and plans related to the management of capital and liquidity,*
- *mandate, resources and budgets for oversight functions, and*
- *internal and external audit plans.*

Challenging, advising and guiding senior management, on:

- *significant operational, business, risk, and crisis management policies and their effectiveness,*
- *business performance and risk management effectiveness.*

## RISK CONSIDERATIONS – KEY TO EFFECTIVE STRATEGY

Strategy is at the heart of boards’ discussions with management. How should the organization grow? Is the business model viable? How does the organization compare to its competitors? To answer these questions, boards should understand the risk implications of their various choices. Expansion to a new geography engenders risk. Introducing new products engenders risk. If competitors are not properly understood, there is risk to the business. And today banks face non-bank competitors aiming to disintermediate them from their clients.

Boards should stack these risks against the returns management expects, ensure returns are sufficient to offset risks, help determine and approve the appropriate risk appetite and ensure management’s actions fit within their risk appetite on implementation.

In a world of low GDP growth and low interest rates, increasing the amount of risk accepted - in other words, increasing risk appetite - may offer a viable strategy to grow shareholder returns. Management may believe, for example, that “going down the risk curve” into sub-prime lending or leveraged finance is the way to go. Its board must understand this and agree this is the correct strategy for the institution.

In addition to ongoing discussions on revenues, costs and profitability, boards must ask questions related to risk. Beyond being sufficient to support the business and cover losses expected in day-to-day operations, is capital adequate to cover tail risk situations? What might those situations be? What about liquidity, leverage and funding? The financial crisis showed these considerations to be vital to financial institutions’ survival. While boards are not expected to act as treasurers, they should challenge management on all these fronts.

Credit risk is at the heart of banks’ traditional financial risk as they lend clients’ funds invested to their borrowing clients – risk emanating from whether these loans are repaid or not. Generally, boards do not consider risks at the transactional level however understanding overall credit portfolio risk is critical. Given demands for growth, boards must answer how big is too big? How much exposure to commercial real estate? How much exposure

to a single client? The answers should be dynamic and consider growth in the bank’s capital and improvements in the credit parameters of the client or sector. What about when the opportunity to grow exceeds the bank’s growth in capital? What happens if the client or sector’s credit parameters weaken? Stress testing has taken a central role in regulatory enhancements since the financial crisis. It can play an important role in determining risk appetite and assist in answering the “how big is too big” question.

Global banks have significant trading operations which create market risk. The complexities of price valuations, basis risk, derivatives and synthetics require a myriad of models to calculate VaR, stressed VaR, CVA, DVA, FVA et al. The financial crisis highlighted the risks that can arise when complexities are not properly understood and positioned within approved risk appetite parameters.

## NON-FINANCIAL RISKS

In addition to financial risks, boards are increasingly realizing they need to consider non-financial risks. Traditional operational risk is expanding to include risks related to banks’ cyber security and fraud, conduct, AML/BSA compliance, tax, legal, controls, third parties, and resilience. These risks are not homogenous, they can be caused by tail events that might seem implausible, and metrics and mitigating actions can be hard to define. To recognize the growing significance of these non-financial risks, banks are considering establishing a new non-financial risk board committee as was recommended by the Prudential inquiry into the CBA.

Conduct relating to how banks treat their clients, how they participate in markets, and how their employees behave, internally and externally, are all matters that boards need to weigh in on. As implications of bad conduct can pose stability-threatening risks, compensation policies should reinforce good conduct and penalize bad conduct. Setting the tone from the top starts with the board and is the right thing to do.

Over the last decade, close to US\$ 30 billion in fines has been imposed on global banks - BNP, HSBC, the CBA and Deutsche Bank to name a few - for violations related to money laundering, KYC or sanctions violations. Lessons learned from these situations point to the need for

boards to gather comprehensive information, effectively challenge management on risks being reported, and require issues to be identified early and resolved with urgency.

Cyber risk usually tops the list of boards' concerns. Could attackers steal money? Could attackers steal data? Could attackers deny the delivery of service? As boards consider defensive actions and the investments required, concerns remain as attackers are constantly searching for and attempting to exploit weaknesses. Boards worry about the attacks, their potential impacts and whether they are doing enough to both fend off attacks and recover should they occur. Is \$10 million enough to spend to counter cyber risk? Is \$50 million? Is \$100 million? At some point, boards must determine the cyber value at risk and match the appropriate defensive investment against it.

Climate risk, considered non-financial, is very much emerging. The UK's Prudential Regulatory Authority (PRA) expects bank's boards to understand and assess the financial risks from climate change that can affect them, to be able to address and oversee these risks within their strategies and risk appetite, allocate responsibility for identifying and managing these risks to the relevant senior executives and exercise effective risk management oversight and controls. Further, the PRA expects boards to ensure that adequate resources, skills and expertise are devoted to managing financial risks from climate change.

Finally, while there are many financial and non-financial risks that boards must consider, perhaps the most important one is the risk to their banks' reputations. Each of Wells Fargo, the CBA or Danske, their reputations each severely impacted, could have avoided their challenges had their boards acted differently. To this end, boards must ensure that effective crisis management plans are well thought through and ready to roll out.

## SETTING THE TONE

In today's complex environment, risk is multi-faceted and dynamic. Banks must consider all risks, financial and non-financial, that can potentially impact their health and stability. Setting the tone from the top starts with their boards. They play an integral role in challenging, advising and guiding senior management teams as they consider these risks and how to mitigate them.

Risks, well understood and well managed, will not keep management and their boards awake at night!



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