The Importance of Risk Oversight by Boards

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The role of the board of directors among other things is to assess the overall direction and strategy of the business. It is also generally accepted that the full board has overall responsibility for risk oversight, mirroring the board's responsibility for overseeing strategy. If the board is to fully understand the company's corporate strategy, it also needs to determine the risks inherent in that strategy. If the full board is responsible for monitoring execution of the strategy, it needs to understand whether the critical risks are being managed effectively. Today, the boards of larger companies are supported by specific Committees such as the Audit Committee, HR and Compensation Committee and Governance and Nominations Committee. This is the traditional approach. However, this approach throws up an important gap. While the board is responsible for engaging in 'strategy', which by definition is forward looking, most of what a traditional board reviews and takes action on, is backward looking. It is pertinent to note that when a company plans to access the capital markets, the focus of its disclosures is on the future, the expectations of future growth and strategy and the risks that are intrinsic to the company's business strategy.

Through the risk oversight process, the board of directors is supposed to gain an understanding of the critical risks inherent in the corporate strategy, accesses useful information from internal and external sources about the critical assumptions underlying that strategy, remains alert to organizational dysfunctional behavior that can lead to excessive risk taking. They are also required to provide input to executive management regarding critical risk issues on a timely basis. This is easier said than done as there is substantial information asymmetry between the board and executive management on the functioning of the business. The Audit Committee spends most of its time scrutinizing financial statements that are based on history. If in crisis mode, it is engaged in the present situation trying to solve problems. In most cases it does not look at the future on a continuous basis and does not align with existing or emerging risks with strategy which is one of the board's main objectives. So, are Boards up to the task? To bridge this gap, at least in regulated financial institutions, there is the Board Risk Committee. However, most nonfinancial companies, do not have a Board Risk Committee and the task of risk oversight rests with the Audit Committee where the focus is on historical financials and disclosures.

For large complex financial organizations, the role of the Board Risk Committee becomes critical, not just for risk oversight but also for risk related disclosures to the public on which future pricing is dependent. For day to day oversight, financial organizations such as banks, insurance companies or investment companies are fraught with risk, and careful management of their assets and liabilities is required.

Typically, a Board Risk Committee stands at the apex of the risk governance structure, overseeing a multitude of risks. Given the criticality, scale and complexity of risk management at large financial organizations, a key question is whether Board Risk Committees have the requisite expertise and credentials to perform their fiduciary duties – including effective challenge of management.

Let me narrow down to the example of boards in large banks across jurisdictions where board directors come from diverse backgrounds. Qualifications to be on a bank board risk committee are vague. Generally, they should have sufficient skills and backgrounds to perform their duties on assigned committees. But this leaves much to interpretation – and may be at the root of various failures and risk events experienced over time. Did boards of failed banks before the 2008 GFC really understand the complexity of subprime and nontraditional mortgages and credit derivatives, global linkages, as well as their role in amplifying mortgage credit risk? More recently, in the failure of Silicon Valley Bank in 2023, were board risk committees well-informed in interest rate and liquidity risk management? Did they understand key concepts, of asset liability gaps, interest rate risk and liquidity risk management? The quick answer is that very few board risk committee members had the direct risk management experience needed to ask hard questions of management teams, about how these and other risks were being managed until it was too late.

A study by Clifford Rossi for the Global Association of Risk Professionals, created a set of categories specifically for Bank Boards, reflecting the backgrounds of those members who had direct bank experience; members who had regulatory experience; and members with backgrounds in other nonbanking sectors. The banking category was further segmented into financial (asset-liability, credit and counterparty risk) and nonfinancial risk and business expertise, while the nonbanking category was split into risk management and business experience. A total of 103 "experiences" across the 58 bank risk committee members were identified. Of those experiences, only 19.4% were associated with bank financial risk management, while another 20.4% had some type of bank nonfinancial risk background. One-third of risk committee members had backgrounds from sectors other than banking. Only three percent of those non-bank members had direct risk management experience of practices familiar to banking. Only five percent of risk committee members had regulatory experience. The inference is that large banks do not stack their board risk committees with risk experts noting that one-third of risk committee members have no direct bank risk management, regulatory or business experience, and no amount of board training is going to turn a risk committee member with experience outside banking into a risk expert. This lack of risk expertise is makes investors, institutions and their shareholders quite vulnerable especially surfacing during times of deep stress. When this happens, as we saw recently, the CEO deflected blame on risk and audit.

This brings to the fore the critical role of the Chief Risk Officer (CRO) in advising the board risk committee with hard date, facts, analysis which individual board members might not possess. The role of the CRO has evolved in recent times and initially the CRO used to report to the CEO. However, the CEO and CFO are focused on revenue and profit targets and not necessarily on risk. Madelyn Antoncic was the CRO of Lehman Brothers till 2007. As the firm's chief risk officer it was her job to know those risks and communicate them to the rest of the senior leadership team. But the CEO and executive management were not interested in hearing what she had to say, and Lehman lost its way and failed. As detailed in the examiner's report about Lehman's collapse, risk management was repeatedly overruled and CRO Antocic was fired. This happened in other banks and financial institutions too. This led the Basle Committee on banking supervision published its new corporate governance guidelines which recommended that CROs need to be independent of executive management and report to the Board and not the CEO and the role of the Board Risk Committee was crystallized.

However, as a link between the board and business, the CRO's role is unlike most other executives who operate under focused set of targets. Critically, he assists the Board to bring in detailed risk appetites of the business. If the business functions within agreed risk tolerance levels then it operates well but if there are areas that exceed risk appetite it has to be identified, controlled and brought in for discussion between board and management. This is no easy task. An effective CRO has to be a debater, a salesperson, an influencer, a disruptor, a police officer, an accountant, a trader/business manager, a technician, an innovator and more. CROs are expected to protect their firm, enable strategic value creation through effective risk taking, management and oversight or challenge of group-think. In that context, CROs must also adjust to an ever-changing environment and scope, whilst justifying and demonstrating the value they create. Specifically, they must ensure that the perceived costs of managing risks do not exceed the benefits risk management generate. However, CROs are still not perceived as a "must-have" C-suite function across financial institutions.

Huge and complex organizations may find it very challenging to implement effective risk oversight. The noise created enables risks to creep in unnoticed and prevent Board Directors, Business Executives and Chief Risk Officers to focus on business strategy and execution. A lot can go wrong. Businesses are faced with a never ending and changing list of risks, driven by their organizational strategy and setup, industry and the wider global economic/societal/environmental context. New and growing risks such as cybersecurity, climate and wider environmental, social and governance risks surface. They can only control part of them, and as a result, must be ready to respond to many unexpected situations. Thus, Board Risk Committees and risk functions must strengthen their approach to risk oversight by focusing their resources on protecting the core strategic business enablers, monitoring and assessing the culture of the organization and providing a factual real image that board directors and executives need in depth.

In a three eye approach, the frontline business functions should have a structure to become the first eye. They must look at the management of risk processes at the functional level, such as risk and control self-assessment, document risk events, to enable the business to enable the business to manage their risks autonomously. As a second eye, the CRO leads independent risk assessment and assists the Board to oversee business within risk appetite and perhaps sometime increase risk when innovative products come on stream as part of a well-considered and risk assessed business strategy. And of course, as a third eye Audit should check on whether risk management is being performed effectively. Whether auditors are fully up to the mark to do this at present is the subject of a separate debate. The Boards job is threefold - hindsight, oversight and foresight. Without effective risk management, board oversight would be based more on hindsight rather than foresight.