Risk Management and the Board of Directors: Suggestions for Reform

by Richard Leblanc

The causes to the global financial crisis are multiple and interdependent. What is reasonably clear however, is that the directors on boards of significant financial institutions in the US and UK did not possess level of understanding of risk necessary to properly oversee management and the complex products and risks being approved. This lack of understanding is a result of the dominance of agency theory and regulations implemented after WorldCom and Enron in 2002 (including S-Ox and the NYSE listing standards). These regulations and listing standards emphasized structural independence of boards of directors and board leadership. What this means is that complex investment banking boards and board committees were led and populated with non-executive chairs and CEOs of unrelated industries who were regarded as formally "independent," yet many lacked solid banking experience. Boards did however comply with regulatory requirements at this time.

Regulators lacked sufficient communication and resources to oversee (or even in some cases understand) the complex systemic risks and derivative products. Scholars were of the view (Dalton, 2009, in press) and did express concern in 2002 (Westphal) that research does not support a causal or systemic relationship between board independence and leadership on the one hand, and effectiveness of the board and performance for shareholders on the other. A director could sit on – or indeed chair – the risk committee or the board of a large investment bank without risk literacy.

The rules and regulations have since changed in the US and UK. In the US, in citing the author's work, a new SEC rule now requires disclosure by listed companies of incumbent and prospective director qualifications, skills and experience. In the UK, a new Code provision calls for a balancing of director skills, experience and knowledge of the company, with director independence, in constituting the board.

In Canada, based on the author's work, he had recommended to regulators and institutional shareholders that a regime be implemented focusing on position descriptions for board and committee chairs of listed companies, a competency-based recruitment model for individual directors, and that individual directors be assessed on an individual basis based on the achievement of their relevant position descriptions and the competencies and skills each director is expected to bring to the board. These practices have since permeated to government and not for profit boards, including linking the re-nomination of a director with that director's assessment by other directors. Banking institutions have had to recruit and assess directors on the basis of competency since 2005.

What is clear now is that standard-setters – including the Basel Committee on Banking Supervision, the Financial Stability Board, the Senior Supervisors Group, the UK Corporate Governance Code and others – have begun to emphasize the individual competencies of directors and board chairs, including specifically in respect of banking knowledge and risk management.

The adjustment of performance metrics (ex ante) and awards (ex post) as a result of risk is developing. Metrics such as TSR, revenue, profit, turnover, market share per se lack robust adjustments for risk, in financial institutions in particular. Compensation committees, management and advisors should be tasked with implementing robust risk-adjusted compensation and meaningfully disclose the achievement of this to regulators and other stakeholders.

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Second, the stature, compensation, independence and reporting structure of the risk function within the organization should reflect the importance attributed to this role for the company. The risk function (e.g., CRO, or otherwise) should have a direct line of reporting to key board committees and the board itself.

Third, directors on a board should have unambiguous authority to insist upon, as and when necessary in the board's or a committee's discretion, independent, combined assurance for any material business risk and related internal controls and accountability being attested to by management, both for financial and non-financial (or sustainability) risks. The assurance provider should report directly to the board or committee, and funding should be provided by the company. When education on risk management and internal controls is required, it should be provided to the board, relevant committee or individual director, as requested.

The foregoing reforms – including the recruitment and assessment of directors with a view to their knowledge of the industry and risk management and leadership qualities; the proper reporting of risk by management; the implementation of a risk-adjusted compensation regime; and the retention of assurance providers over risk, would go a long way to ensuring the effective governance of risk by a board of directors. Risk managers have a key role to play.

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